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Book Reviews

Council for Social and Economic Studies

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Roger Pearson
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The Case for an American Manned Mars Mission

Taylor Dinerman
New York

NASA has assumed that any manned Mars mission will be an International one. Given the problems with the International Space Station and the inherent problems associated with U.S. participation in aerospace projects, the case for an international program is weaker than might generally be appreciated. A U.S. Mission would be simpler and less costly in the long term.

Key Word: NASA, Mars, spaceflight, planetary exploration, International Aerospace Programs

> The goal of America's human spaceflight program – openly stated or not is the exploration of Mars
>
> *Louis Friedman,* The Planetary Society

America is a great nation. Great nations do great deeds. Sometimes America develops a cure for polio or anew treatment for diabetes. Sometimes we carefully place evil empires in the ash heap of history, and once upon a time we flew to the moon. Since then, the space *program had not* achieved the kind of great things it once seemed to promise. The space shuttle is *not cheap* reusable space truck it was supposed to be. The space station is moving ahead slowly and painfully – partly because of politics (though these problems have eased of late) and partly because the Russians are in deep trouble and don't want to admit it.

In July, 1989, when George Bush laid out his idea for what America's manned space program should look like, he split it into three parts – one, the space station, two, a return to the moon, and three, a mission to Mars. This was exactly the program that space enthusiasts had wanted since the end of the Apollo missions.

When George Bush spoke it had been 17 years since any human had ventured outside of earth's orbit. The last moon mission had been in 1972. Since then, America's space program had mostly centered on the space shuttle – its triumphs and its disasters and its hard won rebirth.

Now, in 1998, it looks like we are going to send people to Mars.

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We know how to do it. Only the political will is lacking. We also have to decide who else is going along for the ride. It is often assumed that any Mars mission will, of necessity, be an international project – that America just cannot afford to do it alone, as we did during the glory days of the Apollo project when NASA was spending 0.08% of U.S. GNP, roughly 30 billion in today's dollars, instead of 13.67 billion NASA will get in FY 1999.[1]

NASA had always dreamed great dreams. As NASA historian and critic Howard McCurdy put it: "From the beginning, NASA officials saw themselves as advocates of missions that were considerably beyond what the president and congress had actually authorized."[2] Dan Goldin, the agency director, has recently asked his people to come up with a mission that could be done for about 25 billion, presumably over ten years.

In the final years of the Cold War, the idea of space cooperation with the Soviets became popular with those who were looking for a way out the "Logic of Conflict." The late Senator, Sparky Matsunaga (D), of Hawaii, proposed both a joint space station and in his 1986 book, the "The Mars Project,"[3] a joint U.S./Soviet manned Mars mission. The senator wrote that "the United States bears a special responsibility not merely to follow, but to lead in the move towards greater and enduring cooperation in space,"[4] – a fine idea, but one that leaves the space program vulnerable to the kind of corruption and bitter disappointment that now seems to be lurking in the shadows of the international space station.

When George Bush proposed a manned Mars mission, the idea was immediately sneered at by his political enemies in congress: "There's no such thing as a free launch," was one widely reported reaction, but what really killed his dream was the NASA study that put a 450 billion dollar price tag on the mission. In 1990, Bush proposed a 24% increase in NASA's budget.[5] He did not get the

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[1] *Space News*, October 12, 1998.

[2] *Inside NASA. High Technology and Organizational Change in the U.S. Space Program*, p. 74, Howard E. McCurdy, Johns Hopkins University Press, Baltimore, 1993.

[3] The Mars Project: Journeys Beyond the Cold War, Senator Spark M. Matsunaga, Hill and Wang? New York, 1986.

[4] Ibid., p. 161

[5] *Mars Beckons the Mysteries. the Challenges. the Expectations of Our Next Great Adventure in Space*, p. 157, John Noble Wilford, Knopf, New York, 1990.

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money. The political stars were just not lined up right for Bush's dream of an Apollo-like push to put a man on Mars.

Even more than Apollo, the shuttle is an excellent example of what happens when space technology and politics interact. In the early seventies, NASA and the U.S. aerospace industry had the technology to build a fully reusable space shuttle – the two stage to orbit idea. It was going to be expensive and in the bitter and disillusioned atmosphere of the time, neither President Nixon nor the Democratic congress felt they could afford it. Also, Nixon was obsessed with the Kennedy's and, rightly regarding the Apollo program as their legacy, he chose to let it shut down and gave NASA the go ahead to build the space shuttle as a low cost low risk program that ~ was to be his legacy. As it turned out, the shuttle was neither low cost nor low risk, but ironically Nixon's system with all its many flaws has been operating for more than 17 years while Apollo hardware was used by astronauts from October, 1968 until the July, 1975 Apollo-Soyuz flight.

When the shuttle program began in 1972, NASA promised a lot more than it could deliver within the budget it was given. Everyone had assumed that because the individual technologies were well understood, they could be integrated into the shuttle system without too many problems. The integration of these technologies took longer and cost more than anyone anticipated. When the shuttle began to fly in 1981,it was assumed that the problems had been solved. It was never made clear that the vehicle was still basically a prototype.

The Challenger disaster of 1986 made the critics look good and destroyed what was left of the old NASA mystique. In one of his best speeches, Ronald Reagan promised that we would go back to space and that we would build the space station. While the critics did a little dance of triumph over what they assumed was the dead body of America's space program and the French and their partners took a near monopoly over the business of launching commercial satellites, NASA picked itself up and painfully went back to work.

Getting the shuttle flying again was not easy. As an institution NASA was on the hot seat, while various commissions apportioned blame and some bureaucrats played "cover your ass." Politicians looked for scapegoats. Policies changed to reflect long ignored realities. The shuttles went back into orbit and the dream did not die.

The space station was the logical next step. Sadly, the design and

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funding process brought out the worst in both NASA and in the politicians. The whole program was kept on a short, budgetary leash. NASA failed to work out a realistic budget and congress responded by putting the whole program through the "perils of Pauline," coming within a single vote of killing the whole project in 1993. The incoming Clinton administration, like Nixon, wanted to put its own stamp on the space program. It turned what had been an American program with some international participation into an "American-led" international] program, now known as the international space station (ISS).

Thus they got rid of the "cold war" Reagan-Bush title, Space Station Freedom."

The congressional space enthusiasts, who were more and more concentrated in the GOP went along on the principal that something is better than nothing. The International Space Station (ISS), sometimes known as Alpha, is 70% paid for by the U.S. Two out of three of the initial elements are Russian. The Europeans, through the European Space Agency (ESA) and the Japanese are building modules, while the Canadians in keeping with their expertise are building the station's remote manipulator arm. As a matter of record, the Canadians, the Japanese and the Italians are the only ones who have fully held up their end of the complicated series of bargains, tradeoffs and contracts which form the legal architecture of the ISS

The Russians who were brought into the "critical path" by the Clinton administration have failed over and over again to keep their promises. Ralph DeGennaro of "Taxpayers for Common Sense," quotes congressional testimony to the effect that "in 1994 there were no safeguards to guarantee that corrupt bureaucrats would not siphon off U.S. money into other programs."[6] From now on it will be almost impossible to sell congress on the idea that the Russians can be regarded as reliable partners in any future space venture. The experience on their Mir station has been valuable, but the cost in both anguish and cash for working with them on the ISS should disqualify them for most future partnerships.

The U. S. has done better, but not all that much better. Still, we have not asked anybody else to bail us out. Boeing's problems

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[6] *Space News,* October 26, 1998.

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building the first U.S. element "node one" or "unity" as it's been renamed, have been embarrassing to say the least.

The Europeans first demanded that NASA give them control over the design and construction of the station's full time "lifeboat" or Crew Rescue Vehicle (CRV), designed to ultimately replace the Soyuz capsules used in the early stages of construction. Then they decided they wanted a partnership with NASA on the CRV program, the first phase of which is known as the X-38, and now the French flat out refuse to spend a centime on that program. The French socialist minister of science and education, Claude Allegre, is a hysterical enemy of human spaceflight and will no doubt be remembered as the author of the stupidest French policy since Napoleon sold off Louisiana for pennies per square mile to finance his conquest of Spain.

In spite of all the delays and disappointments, the ISS is more or less on track. By the time this is published, the first two elements should be up. Whether the third critical Service Module is launched on time – as of November 1998, on time means in July, 1999 – will determine the fate of Russia's space program. If they fail after all the money the U.S. has given them they will lose their current status as one of the premiere spacefaring nations.

Under current circumstances, they've done well to gain a nearly equal share in the building and running of the ISS while contributing less than 15% of the cost.

The scientific community has been seriously divided on the value of the station, but many of the leaders believe that the scientific rationale for building the ISS, which was never the whole reason gives them a *droit de regard* over the program. Some useful science will no doubt be done on board the ISS, but the most important research done on board the ISS will be the information we gain on how to do long duration spaceflight. With all the good will in the world the cost of going into orbit is still the biggest obstacle to space exploration. Reducing the cost of putting a pound of payload into low Earth orbit from 10,000 dollars to 1,000 or less is one of NASA's major goals. The idea of a single stage to orbit space craft, or as NASA now calls them, Reusable Launch Vehicles (RLV's), has now been accepted. What is wanted is a ship that operated with the reliability and safety of a airliner. The whole culture of building and launching rockets is changing from the old ideas that grew out of

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military rocketry to something more like a commercial venture. The Lockheed Martin X-33 and its follow-on, the Venture Star project, will, if successful, revolutionize the economics of spaceflight. And even though they will be subsidized by the government to one extent or another, the age of very large government managed rocket programs is coming to an end.

It is often said that no single nation can afford the huge costs related to any single space program. America could certainly afford to spend five or six billion dollars a year over the next ten years to pay for a manned Mars mission and there are ways to do it for two or three billion a year which is roughly the cost of the ISS program. Like the cost of computers, the cost of space flight is constantly diminishing. Old fashioned competitive pressure is doing the job faster and better than the political visionaries ever could.

While costs are coming down, the tools and techniques for taking us to Mars are almost all available. Bob Zubrin laid them out in his 1996 book, "The Case For Mars,"[7] from which has been adapted the title of this article. Zubrin is the best kind of American visionary – a practical engineer with his head in the clouds and his feet on Earth, at least so far. His basic idea is to use Martian resources to provide the fuel for the vehicle which would be used to return the first astronauts to Earth. He calls it a live-off-the-land approach. In 1992-93, Zubrin and his team at what was then Martin-Marietta, demonstrated they could build a relatively simple apparatus that would make rocket fuel out of liquid hydrogen and carbon dioxide gas.

The basic idea is that by using a small amount of liquid hydrogen brought from Earth, such a machine could use the abundant carbon dioxide gas in the Martian atmosphere to fuel the spaceship that would take our astronauts back to Earth. In his plan, even before the expedition left earth, it would have a fueled and ready vehicle waiting on Mars to take them home.

The first mission would leave behind another Earth Return Vehicle (ERV). Thus each mission would build on the one that came before. As more facilities and hardware accumulate on the surface,

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[7] *The Case For Mars: The Plan To Settle the Red Planet and Why We Must*, Robert Zubrin with Richard Wagner, The Free Press, New York, 1996.

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a permanent Mars base will be established. From there, human exploration and eventually settlement can develop.

To pay for and manage the proposed Mars expeditions, Zubrin offers a choice of three models – the JFK model, roughly the same as the Apollo program, the Sagan model, named after the late astronomer, Carl Sagan, which is to mount an international expedition on the same kind of basis that they're using to build the ISS and the Gingrich model, based on the idea of providing a prize to whichever consortium accomplishes the feat, similar to the prize which Charles Lindbergh won on his flight to paris in 1927.

None of these models correspond to today's political reality, but a combination of them might work. An expedition to Mars 90% paid for by the U.S., perhaps with some Japanese and Canadian participation, built around technologies and systems developed using prize money as incentives, is the sort of thing that might pass must with a future congress. NASA is already working on solving some of the problems associated with future Mars expeditions. The agency is spending about 10 or 15 million dollars a year on such programs. It's a small step, but a valuable one.

In November, 1988, writing as president of the recently formed Mars Society, Zubrin proposed that NASA be given more money, both for the robotic exploration of Mars and for the Human Exploration and Development of Space (HEDS). A total of 380 million in new spending for the FY 2000 budget so that the new administration in 2001 will be able to decide whether it wants to go to Mars or not.[8] If so, the new administration will have to decide if it wants to make it an international program or an American one.

The loss of control and the complications involved in the internationalization of the space station might be acceptable in low Earth orbit, and even there, the delays and cost overruns caused by the delays are so frustrating and so embarrassing that the whole thing is less a symbol of international cooperation than a symbol of why countries with incompatible interests and traditions should not attempt this kind of cooperation, if only for the sake of keeping hostility to a minimum. It's impossible to ignore Russia's interest in damaging and delaying the ISS program. They seem to want to bring

[8] *Space News,* November 2, 1997.

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us down a few pegs. Every Russian delay is a sort of victory for them and a defeat for us, not to mention a chance to pick our pockets.

Cooperative international aerospace programs are, as a rule, late over-budget and almost always ill-conceived. Even the best of them, like the British, German and Italian Tornado fighter-bomber program had serious problems that took a long time and a big investment to work through. Last year it was claimed[9] by a knowledgeable aerospace writer that the new Eurofighter, a British, German, Italian and Spanish program would cost more than 400 million pounds extra due to German attempts to make it a "less expensive aircraft."

For the U. S., the problem is that we do not have a political tradition of working in these kinds of cooperative ventures. Our system of separation of powers works against it. The Europeans have developed such a tradition, largely in the name of "Building Europe," as the Soviets were once "Building Socialism." The French believe that they are exceptionally good at squeezing every bit of economic and political advantage out of such programs. The record, however, shows that the Germans are the real champions. On the whole, huge multinational, multilingual, multicultural efforts like these are more trouble than they're worth.

Not only more trouble, but any multinational Mars effort would, almost by its nature, be incompatible with European and especially French commercial interests. The new Ariane 5 medium/heavy rocket not only has had the normal growing pains associated with any large technologically complex project, but has also suffered from a mistake the Europeans (and many Americans) made in guessing the size of future communication satellites. Ten years ago, people thought that as miniaturization got better and better, communication satellites in geosynchronous orbit would get smaller, or if they got bigger, would not get all that much bigger. What has happened is that demand for services has gotten so big so fast that the Ariane 5 booster with its eight tons of payload to GEO is just too small to handle two of the big, new communications satellites at a time, which is what it was designed to do better than any competitor. As things stand, it will not be able to do so until it has undergone an expensive and time consuming upgrade. Their goal is to have the upgraded system ready

[9] *Air Forces Monthly*, November, 1997.

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to go by 2005.

To make Zubrin's Mars Direct idea work, the U.S. would have to begin work on a truly heavy lift Saturn V class booster which might go into production at about the same time as the modified Ariane or perhaps just a few years later. Such a launcher which could put 140 tons into low Earth orbit, and, according to Zubrin's calculations put 28.6 tons onto the Martian surface, could put some very heavy and powerful communications satellites into GEO. Given the shortage of spaces in the GEO, it's a real advantage to be able to fill up your particular space with the biggest and most powerful system available. In any International Mars mission, would the French and their European partners be willing to contribute to a program which would considerably devalue the investment they've already made in the Ariane 5 program?

An American Mars mission would be a national achievement, a bright signal to the rest of the world that the American spirit has not only survived, but will shine for the next century as it did in the last one. In the early 20th Century we constructed the Panama Canal, we built the most prosperous nation on Earth, defeated the totalitarian threat and put a man on the moon. We have failed to build a perfect utopia of world peace and harmony and many in the rest of the world and in our own country will never forgive America that failure.

Mars will never be purely American. After the first few missions the operation should be internationalized, but if the 21st Century is to be another "American Century" then the first people on Mars should be Americans.

To begin a century with a trip to Mars, and to follow it up with a sustained effort to build a self-sustaining colony, there will be the kind of accomplishment that will pay off. Just as the Panama Canal paid off in terms of lower shipping costs and an improved naval position, Mars will pay off in terns of new scientific discoveries, new natural resources, new industries and better environmental protection for Earth. Mars, with all that we will find there and all that we will find out about ourselves by going there will be worth more than any gold mine.

Most important, there is a need for human expansion into the solar system. When the Russian space pioneer, Konstantin Tsilkovski, said in the first decade of our century that "Earth is the cradle of Mankind, but one cannot stay in a cradle forever," it was a remote

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vision. In 1998 it is a real possibility. It is a dream so close to becoming real that more and more Americans believe they can reach out and almost touch it.

In fifty years it should be a cliché.

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Economic Policy, Institutions and Economic Growth in an Era of Globalization

Terrence C. Casey
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The author surveys economic development theory and concludes that policies that conform to a nation's institutional context are likely to be more successful than those involving radical social reconstruction. The author then explores the implications of this argument for the ability of different national institutional contexts to adjust to the changes brought about by globalization.

Key Words: Institutions, economic development, globalization, Great Britain

Understanding the process of economic growth and development is a central concern to academics and policy-makers alike, particularly as the rates of growth across countries vary widely. Clearly the economies of some states do a better job at increasing national prosperity than others. But why? Explaining variations in economic growth and development across countries is crucial, but the answers to these questions are highly controversial.

Within political science, the focus on how to explain this phenomenon has shifted over the years. During the first twenty-five years of the postwar era, Keynesian demand management was held as the *sine qua non* of stable, long-term growth. During this golden age of rapid growth, differences in performance were considered a question of the appropriate fine tuning of the economy within a broadly Keynesian framework. But the Keynesian consensus foundered on the shoals of oil crises and stagflation in the 1970s. Two intellectual and policy trends resulted. First, the elections of Margaret Thatcher in Britain and Ronald Reagan in the U.S. initiated the long march of neoliberal ideas and policy to their currently dominant position across the industrialized world. At the same time, the perception that some states had weathered the storms of the 1970s much more successfully than others focused attention on microeconomic (or industrial) policies. The ability of states like Japan, France and the Asian Newly Industrialized Countries (NIC's) to couple high growth with low unemployment was attributed to the

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various tools of sectoral intervention used to restructure their economies towards competitive, high value-added industries. A flurry of academic works followed, each noting how various policies and institutions of these so-called "developmentalist states" explained their success.[1] Given the stark contrast of these arguments with the neoliberal belief that the state need only retreat from the market to secure growth, academic and political debate throughout the 1980s largely revolved around the pros and cons of industrial policies.

The intellectual ground shifted once again in the 1990s. The long-term efficacy of the neoliberal solution was called into question as Thatcher's Britain and Reagan's America plunged sharply into recession in the early 1990s. Yet the theoretical victory of those who favored more interventionist solutions was short-lived. The late 1990s have seen the return of high growth and low unemployment in America and Britain. In contrast, the heroes of the interventionist cause have faltered. The political consensus in Germany and France has been rocked by unemployment stuck in double-digits despite relatively brisk growth. More significantly, the economy of Japan, the epitome of state-led growth, has collapsed, leading to a general Asian economic crisis that has since spread to Russia. Of significance is that it is the very institutional structures of these countries that commentators encouraged others to emulate that are now producing economic failure. The corporatist welfare states of France and Germany burden firms with high labor costs (and thus low labor productivity) and have created a rigid labor market unable to adjust easily to changes in the global economy.[2] The foundation of the "Japanese model" – the close connection between firms and banks, strategically guided by government officials – led to banks maintaining investments in failing firms, which has overburdened the banking system with bad debt and left firms desperate for increased sales and

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[1] Some of the best examples of this line of analysis are Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford, CA: Stanford University Press) 1982.; John Zysman, *Governments, Markets and Growth* (Ithaca, NY: Cornell University Press) 1983.; Peter Hall, *Governing the Economy* (New York: Oxford University Press) 1986.; and Robert Wade, *Governing the Market* (Princeton, NJ: Princeton University Press) 1989.

[2] As Arnulf Baring of Berlin's Free University put it, "We need to face up to the fact that this famous welfare state has destroyed our work ethic and can no longer be properly financed." *Washington Post,* September 16, 1998, A36.

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investment. The result has been negative growth and rising unemployment in Japan, coupled with recession and political upheaval in those Asian economies closely tied via trade or investment to the Japanese market.[3]

Political economy theory has, unfortunately, dealt rather poorly in explaining the vagaries of real economies. The trend over the previous two decades has been to examine "success stories" and encourage the emulation of those policies by other states. That economic crisis should follow in the wake of free market and *dirigiste* reform calls into question the utility of such simplistic cross-national policy transfer. The debate has now shifted from specific policies to the beneficial or restrictive influence of the *broader* political and economic structures in comparative economic performance. Political concerns about appropriate economic structures have dovetailed with a renewed focus on the study of institutions in the social sciences.[4] Although constituting a theoretically and methodologically diverse school of thought, proponents of the "new institutionalism" are united in an epistemological perspective that places political, economic and/or social institutions at the center of analysis and examines how these shape actor preferences and behaviors. In terms of economic development, the emphasis is not just on the policies promulgated by the state, but on the broader social, cultural, political and economic context in which those policies are implemented. [5]

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[3] *The Economist*, June 20, 1998, p. 21-23.

[4] For a synthesis of scholarly arguments with the practical concerns of international development agencies, see David Williams, "Economic Development and the Limits of Institutionalism," *SAIS Review* 18:1 (Winter/Spring 1998), pp. 1-17. Williams notes that agencies like the World Bank recognize that macro-institutional changes are needed to secure growth in donor countries, but that these agencies have limited ability to induce such changes and are unclear as to which institutional structures work best.

[5] Ellen Immergut, "The Theoretical Core of New Institutionalism," *Politics and Society* 26:1 (March 1998), p. 5-34. The best example of this school of thought from the economic perspective is Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge, UK: Cambridge University Press) 1990. The importance of cultural context is explored in Robert Putnam's *Making Democracy Work* (Princeton, NJ: Princeton University Press)1993. Oliver Williamson has highlighted the importance of business institutions to a firm's success. See especially, *The Economic Institutions of Capitalism* (New York: Free Press) 1985. William Lazonick, *Competitive Advantage on the Shopfloor* (Cambridge MA: Harvard University Press) 1990 examines how organization at the shopfloor level alters the productive restructuring.

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This article explores the utility of institutionalist analysis for questions of comparative political economy. It is necessary first to examine in detail the policy-oriented literature which constitutes the institutional approqach and explain why this viewpoint cannot consistently explain variations in economic performance across time and space. By treating all economies as interchangeable, this perspective – in either its free market or statist variant – fails to account for the significant influence of a state's political and economic structures on the potential efficacy of various policy options. In contrast, the institutionalist research project focuses attention directly at the institutional structures of a given place and how these condition the decisions made by social actors. As such, it offers a more tenable framework for explaining variations in performance, and offers more useful guidance for formulating economic policy.

The current institutionalist literature, nevertheless, suffers from numerous conceptual and operational shortcomings, especially a tendency towards determinism that implies little scope for policy to alter economic outcomes. Economic institutions are thought to be determinative; if the institutional context augers against growth, then the policies implemented within that context can do little good. As a corrective, a framework for comparative political economy is presented that integrates both policy and the institutional context in which policy is implemented. This approach examines issues of growth and development not only as a question of the policies pursued by the state and other actors, but also how these policies "resonate" through the given institutional context. This essay argues that the national institutional context, by altering the opportunity costs of alternative paths of economic adjustment, is a crucial intervening variable through which economic policy must flow and alters the probability of different economic policies producing growth and development. Given this, policies that are successful in one context may not be in another. As such, the key to economic growth is not any particular collection of economic policies, but rather selecting the optimal policies for the particular (national) institutional context in which adjustment must occur. In simple terms, *economic policies are most likely to achieve their desired goals when the institutional, social and cultural structures of a place produce or*

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encourage activity that matches the behavioral assumptions of the policy.

Finally, although the point cannot be fully developed here, this framework provides a better tool for understanding how processes of globalization influence economic development. By highlighting that social actors respond differently to the opportunities and constraints of a more mobile global capital structure, it offers a clear explanation of why the neoliberal economies of the United States and United Kingdom are performing better in the late 1990s than the more state-directed economies of France, Germany and Japan and, alternately, why those economies performed better in a less "globalized" international economic structure.

Policy as a Causal Variable: Free Markets vs. State Intervention

Two questions are central to the theoretical literature on comparative economic performance: (1) Why do some economies consistently perform better than others? (or, stated in the negative, Why do persistent suboptimal economic outcomes occur in some economies?); and (2) In an economy plagued by persistently poor economic performance, how can political and economic actors and institutions break such a vicious cycle? Should economic adjustment be state-led or market-led? The bulk of political economy research over the last twenty years has emphasized the policies implemented by the state, with the main division being between those who see persistent poor outcomes as the result of market forces being blunted and advocate a laissez-faire approach, and those who see failure stemming from a lack of coordination between economic actors within markets, and advocate an activist approach. These approaches are termed here the "free market" and "statist" views, respectively. A thorough review of these arguments and their shortcomings will reveal, however, that they cannot fully explain or provide universally valid solutions for problems of industrial restructuring.

The failure of an economy to restructure its industrial base in order to remain competitive is generally conceived of as an example of *market failure* – the failure of the market to bring about the allocation of resources that best satisfies the wants of society (the Pareto optimal outcome). Market failures obtain because of *externalities*: when one economic agent's actions affect the utility or

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production function (positively or negatively) of another.[6] Market failure occurs when individual profit-maximizing considerations fail to bring about necessary restructuring efforts. Investment in R&D is essential to increase productivity, but from the perspective of an individual firm, it may be unprofitable due to the difficulty of reaping proprietary profits. In this instance, profit maximizing activity by individual agents leads to a socially undesirable underproduction of research capital.

The free market (or neoclassical) school identifies the sources of market failures in distortions in the market, and advocates a laissez-faire response in order to achieve efficient restructuring. Starting from the assumptions of traditional economics, individuals are portrayed as rational, utility-maximizing, efficient economic actors. Resources are scarce, thus competition through markets is pervasive and markets invariably move towards an equilibrium (market-clearing) price. Individuals are guided in their behavior by price signals, which, it is assumed, transmit all relevant information to both consumers and producers ("frictionless" exchange). Resources will thus be shifted to appropriate (i.e., efficient) activities; thus markets are "self-corrective" (i.e., Pareto efficiency and market performance correspond). Obviously these assumptions represent abstractions, not an empirically accurate portrait of the real world. Yet in his famous methodological defense, Milton Friedman argued that the assumptions of a model can be unfounded as long as its hypotheses yield valid and parsimonious predictions. We can thus treat the world "as if" it behaved as such because it produces correct predictions.[7]

Neoclassicists argue that the engine of economic growth is the efficient allocation of resources. If prices reflect social opportunity costs, profit incentives will drive the economy to its maximum productive potential. If prices do not reflect social opportunity costs, it is because distortions in the market (i.e., subsidies paid to steel

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[6] Richard Cornes and Todd Sandler, *The Theory of Externalities, Public Goods and Club Goods* (Cambridge, UK: Cambridge University Press, 1986), pp. 29-30.

[7] Milton Friedman, "The Methodology of Positive Economics," in Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 3-43. Hodgson, Chapter 2 for a critical review of neoclassical methodology.

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producers) altered price signals, leading to inefficient resource allocation (i.e., the overproduction of steel).[8] The solution is the elimination of price distortions, especially those created by state policies, which will produce an optimal economic structure.

Neoclassicists do not completely reject the idea of market failure or state intervention, but maintain a constrained view of the sources of market failure and necessity of government intervention.[9] "Public goods" are the most commonly cited case of necessary state intervention. Neoclassicists note, nevertheless, that few goods truly are public goods, particularly when it comes to excludability.[10] Claims of necessary intervention should thus be viewed with a jaundiced eye and should only be undertaken if the problem cannot be solved through more precisely defined property rights.[11] Assuming that state intervention is deemed necessary, free marketeers raise further red flags in the potential for "government failure" in the form of regulatory capture by interest groups, administrative incompetence, the possibility of predatory state action, etc.[12] Even if the state were to intervene, it is not clear that the outcome will be an improvement over the market outcome. [13]

A more compelling argument against state intervention is that it may induce "rent-seeking" behavior.[14] In plain English, economic

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[8] Wade, pp. 12-13.

[9] Public goods are noted for indivisivibility and inexcludability. Neoclassicists posit four types of market failure: (1) the provision of public goods, which are characterized by nonrivalry of consumption and indivisibility of benefits (e.g., clean air, national defense); (2) the absence of markets, given ownership externalities (e.g., the "nectar market" for beekeepers from a nearby apple orchard); (3) non-competitive markets due to economies of scale and/or collusion; and (4) technical externalities deriving from the indivisibility of knowledge; Bator, pp. 48-57.

[10] Cornes and Sandler, p 7. Many so-called public goods, such as physical infrastructure, are better classified as "club goods" (noted for nonrivalrous consumption, but not non-excludability) and can be provided through market means (e.g., toll roads).

[11] Haa-Joon Chang, *The Political Economy of Industrial Policy* (New York: St. Martins, 1994), p. 11.

[12] *Ibid.* , pp. 18-30.

[13] Peter C. Ordeshook, "The Emerging Discipline of Political Economy," in James E. Alt and Kenneth A. Shepsle (eds.), *Perspectives on Positive Political Economy* (Cambridge, UK: Cambridge University Press, 1990), pp. 16-17.

[14] James Buchanan, "Rent Seeking and Profit Seeking," in Buchanan, Robert Tollison, and Gordon Bullock (eds.), *Toward a Theory of the Rent-Seeking Society* (College Station, TX: Texas A&M Press, 1980), pp. 3-15.

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rents are profits. Used in this context, rent-seeking is distinguished from normal profit-seeking. Profit-seeking by entrepreneurs generates a socially beneficial process of resource reallocation and spurs growth. States create distortions, such as trade barriers, encouraging economic actors to invest resources into seeking the rents that accrue from these distortions, which adds nothing to productive stock of the economy.[15] Economic intervention, even to correct market failures, may still, therefore, prove to be societally negative. William Baumol has added to this concept an historical dimension, arguing that across time, from ancient Rome to modern America, societies' incentive structures (derived both from state policies and cultural imperatives) determine whether entrepreneurial activity will be allocated to productive activities such as innovation, or largely unproductive activities such as rent-seeking. The broad lesson to be learned is that state intervention may divert resources away from productive activities – value allocation rather than value creation – with a concomitant reduction in the production possibilities for society.[16]

Given all of this, the free market school concludes economic growth will best be coordinated by the market rather than the state, and the explanation for variations in growth across states can be found in the extent to which market-distorting barriers are erected by the state. Growth is best achieved by the state that governs least.

The free market argument can be criticized, but the least productive – although most common – point of attack is the empirical falsity of its assumptions. It is an intentionally tautological model and, therefore, is true by its assumptions. The standard to which economists hold themselves is predictive, not descriptive, ability. Attacking the empirical accuracy of these assumptions is thus pointless unless they can be shown to produce poor predictions, an

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[15] Jagdish Bhagwati, "Directly Unproductive, Profit-Seeking (DUP) Activities," *Journal of Political Economy* 90:5 (1982), p. 989.

[16] William Baumol, "Entrepreneurship: Productive, Unproductive and Destructive," *Journal of Political Economy* 98:5 (1990), pp. 893-921. In ancient Rome, for example, Baumol notes the accumulation of wealth was acceptable among the upper-class, as long as it was through landholding, usury, or political payments, not industry or commerce. Commercial and industrial activities were undertaken by freed slaves, who already suffered a social stigma. Thus technological innovations that flourished in Rome were not disseminated across the Empire.

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issue addressed below. Neoclassical assumptions have further been attacked for portraying economics as a relatively autonomous sphere of human activity. Marxists offer the most comprehensive rejection of economic autonomy,[17] but even not explicitly Marxist authors have argued that the organization of production is determined by social choices rather than economic imperatives.[18] However, attempts to elaborate the social "embeddedness" of economics[19] fail in interpreting the neoclassical model literally, thus posing a false distinction between their "socialized" models and the "unsocialized" neoclassical model and making the intellectual leap from rejecting autonomous markets to markets as fully dependent on social (really, state) decisions. The principles of orthodox economics are viewed as invalid or largely amenable to manipulation for social ends without concomitant economic sacrifice. While social institutions do influence economic decision-making, this does not imply a complete rejection of neoclassical insights regarding utility maximization, price signals, market organization, etc.. The focus on social structures should be viewed as complementary, not contradictory, to much of the neoclassical approach.

Two points, nevertheless, raise doubts about the validity of an unamended neoclassical model. The first is the historical record. On the one hand, the record of the communist bloc and a diversity of Third World countries from Brazil to Nigeria to India seems a stark validation of the corrosive effects of state planning. On the other hand, in Japan, the Asian NICs, and much of continental Europe,

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[17] Marx distinguished between structure (economic relations) and superstructure (political, legal, cultural relations). Recognizing that social structures influence economic behavior is commendable, but Marxism presents an oversocialized and deterministic conception of society whereby class conflict overwhelms other potential variables. Marxist approaches subordinate politics to economics rather than explaining how the two realms interact. The French "regulation school" offers a more recent application of Marxist theory to questions of political economy; See Robert Boyer, *The Regulation School: A Critical Introduction* (New York: Columbia University Press, 1990), p. 45.

[18] Michael Piore and Charles Sabel, *The Second Industrial Divide: Possibilities for Prosperity* (New York: Basic Books) 1984.

[19] Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91:3 (November 1985), p. 487.

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spectacular growth was accompanied by significant state intervention.[20] There are simply too many anomalies to accept the neoclassical model uncritically.

A more serious critique is offered from within by otherwise orthodox economists who reject the orthodoxy of neoclassical assumptions. Many traditional economists have questioned the utility of positing a frictionless market in which property rights and information are costlessly acquired.[21] Property rights are not always costless to acquire – you might have to hire a lawyer to defend them. Nor is information costless; one need only consider the time and effort required to purchase a new car. When it is costly to transact, these authors argue, institutions matter.[22] This led to the development of "transaction cost economics".[23] Transaction costs are defined as "...the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing enforcement agreements."[24] In terms of economic adjustment, the prevalence of transaction costs implies that the reliance upon the correct reading of price signals may not be sufficient. An examination of economic institutions is needed.[25] But the key point about transaction costs is not to show that neoclassical assumptions about a frictionless market are empirically invalid. Rather, transaction costs are important in showing why neoclassical *predictions* about market behavior may not stand up.

In summary, the free market model assumes that market

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[20] Besides the works of Johnson and Wade (see f.n. 1), See Jung-en Woo, *Race to the Swift* (New York: Columbia University Press) 1991.; Alice Amsden, *Asia's Next Giant* (New York: Oxford University Press) 1991. For an excellent summation of the role of the state in the development of the East Asian NICs, see Frederic C. Deyo, "Coalitions, Institutions and Linkage-Sequencing -- Toward a Strategic capacity Model of East Asian Development," in Deyo (ed.), *The Political Economy of New Asian Industrialism* (Ithaca, NY: Cornell University Press, 1987), pp. 227-247.

[21] Ronald Coase, "The Problem of Social Costs," *Journal of Law and Economics* 3 (October 1960), pp. 1-44.

[22] North, *Institutions, Institutional Change and Economic Performance*, p. 12.

[23] Oliver Williamson, *Markets and Hierarchies* (New York: Free Press) 1975.; *The Economic Institutions of Capitalism* (New York: Free Press) 1985.

[24] North, *Institutions, Institutional Change and Economic Performance*, p. 27.

[25] Ronald Coase, "The New Institutional Economics," *The American Economic Review* 88:2 (May 1998), pp. 72-74.

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competition will optimize economic growth and development. If suboptimal outcomes occur it is because of market distortions, especially due to state intervention and the rent-seeking behavior it induces. However, this argument is only true tautologically (market distortions are the only possible explanation), is not fully supported by the historical record, and is not terribly useful in explaining variations in performance between countries. By posing all economic actors as interchangeable rational utility maximizers, the free market model underplays the role that specific institutional and cultural structures can have in shaping economic development.

In contrast, the statist view sees pervasive market failure and is optimistic regarding the potential for state-led corrections. Statists argue that the key to economic growth, given different rates of return, is not getting prices right, but getting the sectoral composition of the economy right.[26] The primary motivation of firms in a capitalist economy is profit maximization. On the other hand, a country's potential for growth over the long-term depends upon productivity improvements. While the neoclassical model assumes that these two imperatives correspond, the statist model does not. Poor investment decisions result from a lack of coordination and an incentive structure in decentralized markets that produces individually rational, but socially damaging decisions. The possibility for the underprovision of R&D was cited above; the same logic applies to other areas. Only by altering the incentive structure and coordinating investment can an economy correct such market failures and produce optimal growth. Only the state possesses the authority and resources to undertake such a coordinating role.

The statist position is also subject to numerous criticisms. First, the statists implicitly (and explicitly) assert that there is an objectively optimal industrial structure, an idea best captured by the "manufacturing matters" thesis of Stephen Cohen and John Zysman.[27] Although logical in the abstract, the coherence of this

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[26] *Ibid.* , p. 29.

[27] Stephen Cohen and John Zysman, *Manufacturing Matters* (New York: Basic Books) 1987. Cohen and Zysman contend that high-wage service jobs are tightly linked to a strong manufacturing base, thus the loss of manufacturing jobs will also destroy service jobs. There are numerous problems in positing a dependent relationship between manufacturing and services. First, the relationship between services and manufacturing is better seen as

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argument melts when one gets down to specifics. What sectors are necessary for national prosperity? In what proportions? No country can succeed in all areas of production. Indeed, the Smithian logic of gains from trade via specialization warrants against such a contingency. Thus the argument that a nation must maintain a certain industrial structure has a weak economic rationale.

Statist authors have countered this with the idea of "revealed" versus "created" advantage. The neoclassical conception of international exchange contends that each nation has a comparative advantage in the production of those goods that use intensively the factor(s) that they possess in relative abundance.[28] A nation's comparative advantage is thus revealed by their factor endowments. Critics cite two problems: (1) since, by definition, advanced industrial economies are relatively well-endowed with capital, this theory offers little practical guidance; and (2) nations like Japan and South Korea have created advantages in capital and technology-intensive industries through cooperative market structures and government intervention.[29] Advantages are thus dynamic, not static, and can be created through appropriate state intervention. Accepting that these advantages can be created, on the other hand, is a far cry from agreeing that they should be created. In economic terminology, it is not clear that the opportunity costs of diverting resources into developing "crucial industries" (themselves poorly specified) are consistently more positive than allowing market forces to determine the industrial structure. Advantages can be created through government action, but there is no economic basis on which to

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interdependent than dependent. Second, the line between services and manufacturing is becoming increasingly blurred, as many "products" are often intangible (i.e., computer software). Finally, the need for physical proximity between manufacturing and services is a function of technological change. Thus the prosperity of service industries is not necessarily dependent upon business from manufacturers in the same country. Noting that services are less readily tradable across state boundaries should not obscure that many are in fact traded.

[28] This is known as the Hecksher-Ohlin Theory. See Bruce Moon, *Dilemmas in International Trade* (Boulder, CO: Westview Press, 1996), Chapter 2, for a simple but coherent elaboration of this theory.

[29] See, for example, John Zysman and Laura Tyson, *American Industry in International Competition: Government Policies and Corporate Strategies* (Ithaca, NY: Cornell University Press) 1983.

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conclude that the benefits will always outweigh the costs.

Nor does the statist case directly address the neoclassical point about rent-seeking. To be sure, some authors specify requirements for effective intervention in terms of administrative capacity and state autonomy. Moreover, the prevalence of rent-seeking may also be limited by collective action problems that prevent groups from forming, leading to "oligopolistic rent-seeking", which reduces its posited negative societal costs. The extent to which either possibility is correct, however, can truly only be determined empirically.[30] It is important to note that this calls into question both the neoclassical and statist views on state-induced rent-seeking. Yet the scales tip against the statist view if we accept the general rather than the specific insight of the rent-seeking argument – that government programs distort incentive structures in ways that may produce negative results not intended by the policies.[31] The statist case is, finally, subject to all the government failure problems noted by industrial policy opponents.

In the final analysis, the model is limited both by empirical anomalies and its comparative-analytical method. Despite East Asian success stories, the multiple failures of state intervention call into question the wider applicability of these models. By relying on in-depth examinations of success stories to prove their points, the statists imply that other nations can equally succeed by emulating interventionist policies. As numerous authors have argued, however, to the extent that effective intervention occurred, its foundation rested upon certain fundamental domestic and international political

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[30] Chang, pp. 38-45.

[31] Nor is this purely a speculative concern. Control over financial institutions allowed the French state to control industrial development in the postwar era, but, as Michael Loriaux records, it also created a "moral hazard" -- economic agents came to expect to be able to borrow freely from public institutions, even in times of financial crisis. As a result, it became difficult for French officials to control monetary growth. Thus French control of industrial finance, which had been portrayed as the optimal tool for state-led adjustment, in the end reduced the possibilities for state control. Michael Loriaux, *France After Hegemony: International Change and Financial Reform* (Ithaca, NY: Cornell University Press) 1991. See also John Zysman, *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca, NY: Cornell University Press) 1983 for a favorable analysis of French financial control.

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conditions.[32] Industrial policies removed from such fertile soil contexts are unlikely to blossom.

Some authors have attempted to address these arguments by specifying the conditions under which a statist solution is most appropriate. Some argue that the timing of industrialization relative to other states determines their development path. In late developers the state has a crucial role to play, especially in capital formation and the distribution of technology.[33] Unfortunately, states at similar levels of development have pursued interventionist policies with widely divergent results (e.g., India versus Taiwan), and there is nothing to indicate that late developers require state-guided capital accumulation. After all, industrialization in the United States in the late 19th century was achieved without a major role being played by the central state.[34] Whether state-led or market-led development is optimal is indeterminate based solely on the lateness of development.

This is not to say that international factors are unimportant, as dependency theorists have emphasized.[35] In a more benign view, Frederic Deyo elaborates how American political and economic

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[32] Deyo argues that state-led industrialization in the Asian NICs required "political closure" whereby an autonomous, elite bureaucracy, aided by the military and economic hegemony of the United States, guided development. The U.S. also provided legitimacy to these bureaucratic-authoritarian regimes; Okimoto makes a similar argument for Japan , David Okimoto, *Between MITI and the Market: Japanese Industrial Policy for High Technology* (Stanford, CA: Stanford University Press, 1989, pp. 232-235. See also David Seddon and Time Belton-Jones, "The Political Determinants of Economic Flexibility, with Special Reference to the East Asian NICs," in Tony Killick (ed.), *The Flexible Economy: Causes and Consequences of the Adaptability of National Economies* (London: Routledge, 1995), pp. 325-364.

[33] Alexander Gershenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press) 1962.

[34] A major reason why the U.S. did not need to "squeeze the peasants", as in Germany and Russia, was because of significant foreign investment, mainly from Britain. Stephen Skowronek further explains that the existing institutional structures of the decentralized and administratively weak central state served to blunt calls for greater central control of the economy during the period of industrialization. See Skowronek, *Building the American State: The Expansion of National Administrative Capacity, 1877-1920* (Cambridge, UK: Cambridge University Press) 1982. [But in respect of U.S. 19th century industrialization, it must be remembered that this was protected by high state-imposed tariffs. - Ed.]

[35] They argue that low growth in the Third World is the result of these states' subordinate role and exploitation in the international economic system . Immanuel Wallerstein, *The Modern World System* (New York: Academic Press) 1974.

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hegemony aided economic growth in Asia, both in supporting their authoritarian regimes and reducing their defense burdens.[36] International factors alone, however, cannot be determinative. Peter Gourevitch provides ample cross-national evidence to show that responses to international economic crises are a function of the political coalitions formed behind various policy packages.[37] The level of development and the international economic system may determine the problems faced by states, but they cannot determine whether a statist solution is optimal. Domestic factors must be examined.

One of the main qualifications for the appropriateness of an interventionist solution is whether state bureaucracy is administratively capable and/or relatively autonomous from societal interest groups. State autonomy (the insulation of state decision-makers from societal interests) [38] is held by many authors to be a crucial prerequisite for state-led restructuring.[39] Unfortunately, there are numerous analytical and practical problems in distinguishing between strong (autonomous) and weak (non-autonomous) states. States are rarely equally autonomous across all issue areas, nor are many bureaucracies fully insulated from

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[36] Deyo, p. 241.

[37] Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca, NY: Cornell University Press) 1986.

[38] The literature on the state as an independent variable is vast and cannot be fully explored here. See Peter Evans, Dietrich Reuschmeyer and Theda Skocpol (eds.), *Bringing the State Back In* (Cambridge, UK: Cambridge University Press) 1985.;. Stephen Krasner, "Approaches to the State: Alternative Conceptions and Historical Dynamics," *Comparative Politics* 16:2 (January 1984), pp. 223-246; Gabriel Almond, "The Return to the State," *American Political Science Review* 82:3 (September 1988); Eric Nordlinger, *On the Autonomy of the Democratic State* (Cambridge, MA: Harvard University Press) 1981; Alfred C. Stephan, *The State and Society: Peru in Comparative Perspective* (Princeton, NJ: Princeton University Press) 1978.

[39] Dietrich Reuschmeyer and Peter B. Evans, "The State and Economic Transformation: Towards an Analysis of Conditions Underlying Effective Intervention," in Evans, et al, *Bringing the State Back In*, pp. 44-77.; John Zysman, *Governments, Markets and Growth* (Ithaca, NY: Cornell University Press), 1983. Robert Wade, Frederic Deyo and Alice Amsden all make similar arguments in the East Asian context. See Ezra Suleiman, *Politics, Power and Bureaucracy in France: The Administrative Elite* (Princeton, NJ: Princeton University Press) 1979, for an examination of the causes and consequences of autonomy among the French administrative elite.

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societal influence.[40] Autonomy also presents normative problems in terms of democratic accountability. If bureaucratic autonomy is a necessary prerequisite for state-led restructuring, then few states either can or should fit the bill. Administrative capacity is equally held as indispensable for state-led restructuring efforts.[41] Yet there is an inherent problem of establishing causal connections between administrative capabilities and outcomes.[42] A deeper problem is that administrative capacity can only really provide a negative determination – it is a necessary, but not sufficient, factor for successful state-led restructuring.

Other authors have introduced economic structure, either of whole economy or a given sector, as determining the potential for successful state guidance. D. Michael Shafer maintains that state-led restructuring in developing states stands a better chance if the leading sectors are competitive and have low barriers to entry (e.g., light manufacturing); conversely, capital-intensive and oligopolistic markets (e.g., mining) will be able to resist state manipulation.[43] Zysman contends that French economic planning succeeded in capital-intensive, stable technology industries (steel and oil), but not

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[40] Stephen Krasner argues, for example, that the American state is relatively autonomous when it comes to monetary policy, but in the thrall of special interests on trade. See Krasner, "United States Commercial and Monetary Policy: Unraveling the Paradox of External Strength and Internal Weakness," in Peter Katzenstein (ed.), *Between Power and Plenty* (Madison, WI: University of Wisconsin Press, 1978), pp. 51-88. Harvey Feigenbaum documents that even in the textbook example of an insulated state apparatus -- the elite French bureaucracy -- decision-makers in the nationalized oil industry pursued narrow industry interests rather than the broad public interest. Feigenbaum, *The Politics of Public Enterprise: Oil and the French State* (Princeton University Press) 1985. Even in Japan, the other commonly cited example of an autonomous state, the Liberal Democratic Party (and, concomitantly, state bureaucrats) are very much beholden to certain interests, especially agriculture.

[41] A state-controlled financial system (and thus control of the flow of capital) is necessary, by Zysman's logic, for effective sectoral intervention. Zysman, *Governments, Markets and Growth*; Equally, Chalmers Johnson attributes Japan's spectacular growth to the Japanese "developmentalist state," embodied in the Ministry of International Trade and Industry. Johnson, *MITI and the Japanese Miracle*.

[42] David Friedman specifically raises this point in regard to MITI's role in Japanese growth. See Friedman, *The Misunderstood Miracle: Industrial Development and Political Change in Japan* (Ithaca, NY: Cornell University Press, 1988), pp. 2-3.

[43] D. Michael Shafer, *Winners and Losers: How Sectors Shape the Developmental Prospects of States* (Ithaca, NY: Cornell University Press) 1994.

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in high-tech industries requiring rapid innovation and quick reaction to changing markets.[44] MITI's generally favorable record in Japan through the 1960s and 1970s is marred by a quite unsuccessful attempt to develop a Japanese petrochemical industry – a quintessentially capital-intensive industry.[45] Alternately, David Friedman chronicles Japanese success in guiding the development of their decentralized machine tool industry.[46] That these studies offer contradictory conclusions as to the connection between economic structure and intervention should certainly instill an note of caution. Matching intervention to sectors is problematic, furthermore, because market and organizational structures vary within industries cross-nationally,[47] and even cross-regionally within a country.[48] In addition, the transaction cost perspective argues that the natural boundaries of the firm (and, implicitly, of sectors) are not defined by technology, but also by transaction costs, which are partly determined by the institutional framework in which industries operate.[49] It is, therefore, not possible to make universally valid statements connecting sector organization to successful state manipulation. Sectoral composition may, again, influence the problem-set that states

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[44] John Zysman, "The French State in the International Economy," in Peter Katzenstein (ed.), *Between Power and Plenty* (Madison, WI: University of Wisconsin Press, 1978), pp. 255-295.

[45] Okimoto, *Between MITI and the Market*, p. 6. Okimoto writes: "Here was a case where Japanese industrial policy led directly to serious structural problems....Not that a decentralized market system would have averted this error; the OPEC oil embargo caught everyone by surprise. But Japanese industrial policy exacerbated the problem by pushing the installation of new plant facilities ahead at a faster pace than would have been sustained under a laissez-faire system."

[46] David Friedman, *The Misunderstood Miracle]* (Ithaca, NY: Cornell University Press) 1988.

[47] Martin Kenny and Richard Florida detail the crucial organizational differences between the Japanese and American auto industries. Martin Kenney and Richard Florida, *Beyond Mass Production: The Japanese System and Its Transfer to the U.S.* (New York: Oxford University Press) 1993. Kenney and Florida contend that the Japanese automobile industry is noted for "innovation-mediate production," whereby innovation and production -- intellectual and physical labor -- are integrated.

[48] AnnaLee Saxenian's study of differences in organization in the computer industry between Silicon Valley and the Route 128 area near Boston, for example, AnnaLee Saxenian, *Regional Advantage: Culture and Competition in Silicon Valley and Route 128* (Cambridge, MA: Harvard University Press) 1994.

[49] Williamson, *The Economic Institutions of Capitalism*, p. 26.

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face, but it is only one among many other crucial variables.

In summary, the statist viewpoint is that pervasive market failure may produce poorly structured economies that hinder growth and competitiveness, and can only be corrected through state intervention aimed at altering the structure of the economy. Yet the inability to specify the appropriate conditions for successful intervention in a broadly applicable form limits the utility of these approaches as a guide to policy. Given the various faults cited in both the free market and statist positions, the initial question remains unanswered: Should economic efforts be state-led or market-led? The ultimate difficulty with both the statist and free market interpretations of market failure is that the appropriateness of one or the other as a guide to policy is largely indeterminate. It cannot be said that the costs and benefits of either will, in the net, always be positive. Such a determination can be made, however, using the insights of institutionalist analysis.

Institutions as Causal Variables: *Institutionalism(s) and Economic Change*

Institutionalism[50] is a broad school that covers a substantively and methodologically diverse group of scholars. In political science, institutionalism breaks down into "rational choice" and "historical institutionalist" variants.[51] In economics it is expressed as the "new

[50] For an excellent overview of institutionalist approaches to political science, see Peter Hall and Rosemary C.R. Taylor, "Political Science and the Three New Institutionalisms," *Political Studies* (1996), pp. 936-957. Hall and Taylor outline three "institutionalisms": historical institutionalism; rational choice institutionalism, and sociological institutionalism. Sociological institutionalism is not directly discussed here, although its emphasis on cultural institutions is largely incorporated into the framework developed below. The "new institutional economics" is more applicable to the issues under discussion here and, although a cousin of the rational choice approach, is reviewed as a separate variant of institutionalism for reasons discussed below.

[51] For an overview the rational choice approach, See Peter C. Ordeshook, "The Emerging Discipline of Political Economy," in Alt and Shepsle, *Perspectives on Positive Political Economy*; For an overview of historical institutionalism, see Kathleen Thelen and Sven Steinmo, "Historical Institutionalism in Comparative Politics," in Steinmo, Thelen, and Frank Longstreth (eds.), *Structuring Politics: Historical Institutionalism in Comparative Analysis* (Cambridge, UK: Cambridge University Press, 1992), pp. 1-32.

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institutional economics."[52] The "new institutionalism" differs from the "old institutionalism" in having a distinctly theoretical orientation, as opposed to the atheoretical studies of the first half of the century.[53] There are numerous differences in assumptions and methodology between the variants of institutionalism, but they are held together by a common concern with the centrality of institutions, both formal and informal, in structuring political and economic interaction.[54] They are thus complementary rather than contradictory. It is necessary to examine an example of each of these variants in order to understand how institutional analysis can clarify issues of economic change, but equally how the institutional approach itself requires clarification.

The rational choice approach, in many respects, represents the application of the assumptions and methods of orthodox economics to political phenomena. Rational choice theorists assume that individuals are the basic unit of analysis, and that they are rational[55] utility maximizers within (an exogenously derived) preference set. The key difference from economics is that rational choice explicitly examines the role of institutions, which are held to be important features of the strategic context in which decision-making occurs.[56] Institutions, as such, serve to alter the strategies of rational actors in seeking to achieve their self-interested goals.[57] Like economics, the rational choice approach is tautological in that it assumes that

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[52] For thorough elaboration of the assumptions, methodology and epistemology behind the NIE, see Eirik G. Furubotn and Rudolph Richter, *Institutions and Economic Theory: The Contribution of the New Institutional Economics* (Ann Arbor, MI: University of Michigan Press) 1997 and Jack J. Vromen, *Economic Evolution: An Inquiry into the Foundations of New Institutional Economics* (New York: Routledge) 1995.

[53] For a thorough comparison of the "old" and "new" institutional economics, see Malcolm Rutherford, *Institutions in Economics: The Old and New Institutionalism* (Cambridge, UK: Cambridge University Press) 1994.

[54] James C. March and Johan P. Olson, "The New Institutionalism: Organizational Factors in Political Life," *American Political Science Review* 78:3 (September 1984), pp. 734-739.

[55] "Rational" in this context means that human activity is perceived to be goal-oriented and instrumental, and that individuals try to maximize their goal-achievement given certain preferences. Since preferences vary with different actors, rationality, as such, is subjective. William Riker, "Political Science and Rational Choice," in Alt and Shepsle, *Perspectives on Positive Political Economy*, pp. 172-174.

[56] Immergut, p. 15.

[57] Thelen and Steinmo, p. 7.

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individuals, given certain preferences and constrained by institutions, will seek to optimize their utility. Theorists have used this approach in order to construct formal, deductive models of political behavior.

Mancur Olson has extended his "logic of collective action"[58] to construct a logical, deductive model of economic decline. Olson argues that interest groups proliferate in stable societies. Given their capacity for collective action, these groups will seek economic benefits from the state, leading to the formation of distributional coalitions. But distributional coalitions slow a society's capacity to adopt new technology and redeploy resources in response to changing world market conditions, thus reducing the rate of economic growth. Stagnation and decline follow. Olson contends that Great Britain in the 20th century is the quintessential example of this process in action.[59]

Despite the commendable addition of institutions into the analytical framework, there are numerous shortcomings to the rational choice approach for understanding economic growth and development. First, the rationality assumption is overly constrictive. Like mainstream economics, rational choice is intentionally tautological and the subjective rationality assumption qua assumption is beyond criticism. The question is the ability of such assumptions to provide useful insights to real world problems. There are two difficulties in this regard. First, positing instrumental, subjectively rational actors assumes equilibrium outcomes.[60] In terms of

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[58] Olson sought to explain why some groups (e.g., migrant farm laborers) do not pursue collective action to gain group benefits (e.g., forming a union) even though it is in their interest to do so. He argues that this is because the costs for any individual to organize such action may be greater than the potential benefits. Non-participants are likely to receive the benefits despite inaction, and thus are tempted to free ride, a problem exacerbated in large groups. Olson concluded that collective action problems could only be solved by creating organizational structures that can provide selective incentives to overcome the free rider problem. Mancur Olson, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press) 1965.

[59] Mancur Olson, *The Rise and Decline of Nations* (New Haven, CT: Yale University Press) 1982.

[60] Rational choice models have a "snapshot" quality; they illuminate outcomes at any given point in time. But if the "game" being played is iterated, the model can only account for the preferences and constraints at any one iteration. The approach is thus ahistorical. This is problematic if the process through which institutional constraints are formed has

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institutions, this means that whatever structures and outcomes obtain must be within the utility function of some actor(s) and cannot, therefore, be labeled irrational. It simply assumes away the possibility that institutions could be dysfunctional (irrational) from the perspective of the interested actors, or that institutions could be created and maintained for reasons unrelated to the function to which they are now relevant. To view behavior in instrumental terms, albeit subjectively instrumental, may obscure the true impact of institutions. Secondly, lacking a paradigmatic utility assumption as in economics (e.g., individuals maximize *economic* utility), political scientist must construct preference sets for each individual case, making the approach no less interpretive than any other.[61] Since rational choice treats preferences as exogenous, moreover, the process of preference formation is ignored. But if actor preferences produce suboptimal outcomes, then understanding why preferences were selected may be crucial to formulating corrective policies. For this reason the formalism of rational choice may actually be damaging, in that it cloaks a hermeneutic construct under the pretense of rigor. While that rational choice approach may be well-suited for exploring many areas (Junko Kato contends that it is most useful in determining patterns of individual behavior across diverse institutional settings rather than behavior within a distinct institutional framework), [62] it is poorly suited for understanding broad processes of economic change. More apt tools can be found in the writings of historical institutionalists and the new institutional

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some impact on interaction within those constraints. North, *Institutions, Institutional Change and Economic Performance*, p. 93. In game theory, this is the so-called "folk theorem" -- that an individual game may not have a unique equilibrium and that the process through which play occurs (e.g., iterated games) influences the strategies of the actors.

[61] John Ferejohn contends that both rational choice and historically based analyses are methodologically similar: both start from observed behavior and reconstruct actors' preferences. Rational choice models may be deductive and rigorous, but their construction is largely interpretive. John Ferejohn, "Rationality and Interpretation: Parliamentary Elections in Early Stuart England," Manuscript, Stanford University, January 1990.

[62] Junko Kato, "Institutions and Rationality in Politics -- Three Varieties of Neo-Institutionalists," *British Journal of Political Science* 26 (1996), pp. 553-582. However, since economic development does take place in distinct national institutional frameworks, this approach offers minimal utility in explaining cross-national variations in development and growth.

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economists.

Historical institutionalists reject the strict rationality assumption and focus explicitly on the role of institutions both in shaping actors' strategies and in the process of preference formation.[63] Historical institutionalism treats actor preferences as endogenous – both actor goals and strategies are mediated, but not determined, by the institutional context in which political discourse takes place. The approach is historical in that it examines the process through which institutions are created and develop over time in order to understand their influence on actor choices. The two key propositions of the historical institutionalism are that: (1) institutions shape politics; and (2) institutions are shaped by history.[64]

One of the most noted examples of historical institutionalist analysis is Robert Putnam's widely acclaimed *Making Democracy Work*.[65] Putnam seeks to explain why democracy succeeds in some contexts but not in others by examining local governments in northern and southern Italy. The institutional structures (by which Putnam means formal governmental structures) were the same throughout the country, but on various measures of efficiency and responsiveness, local governments in northern Italy scored consistently higher. Why the variation? Putnam emphasizes that collective action problems – here efficient and democratic local government – must be understood in their historical-cultural context. Democratic institutions thrived in northern Italy, where historical circumstances produced a vibrant civic community, noted by pervasive norms of reciprocity and extensive networks of civic engagement, which collectively he labels "social capital". Southern Italy's institutions were neither efficient nor

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[63] Thelen and Steinmo, pp. 7-8.

[64] Robert Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, NJ: Princeton University Press, 1993), pp. 7-8.

[65] Despite the fame of his work, Putnam is not perhaps not the best representative of the historical institutionalist school. His work is historical in the sense that he explains the variance in successful democracy in terms of historically based choices. He thesis accords more with the rational choice approach, however, in that he uses these past choices to construct a "social game" in which the structure of interaction -- either replete with or devoid of social capital -- serves to shape the choices made by the players. This produces a stable equilibrium, although not necessarily a positive equilibrium.

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responsive, the result of a shortage of social capital.[66] Given the lack of social capital in the south and the persistence of hierarchical patron-client relationships, non-cooperation is a rational response – a stable equilibrium in game theory terms. In short, the institutional solution was the same in both cases, yet the outcome differed significantly. Why? Because, "Social context and history profoundly condition the effectiveness of institutions."[67] Successful democracy is "path dependent": "...where you get to depends on where you're coming from, and some destinations you simply cannot get to from here."[68] Putnam concedes that new local government structures did improve the process of governance in southern Italy, but the broad thrust of his analysis gives causal preference to culture over state institutions. Institutions can change outcomes, but the hand of culture lies heavy for Putnam. Unless the citizenry is inculcated with norms of civic engagement, successful democracy is unlikely.

Making Democracy Work received widespread praise,[69]and is particularly valuable for the insight that the evaluation of institutions must include the wider social and political context in which institutions are nested. Still, Putnam's methodology and causal logic has been attacked by many.[70] Although some of this criticism is

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[66] Putnam traces the roots of civic community in northern Italy back to the self-governing city-states of the late Medieval period, which created a tradition of civic cooperation. In contrast, southern Italy was ruled by a Norman aristocracy which imposed a hierarchical regime, creating a tradition of patron-client relationships that hindered cooperative interaction. Putnam also presents ample evidence to refute arguments that would connect differences in governmental performance to socioeconomic factors. See Chapter 4.

[67] Putnam, p. 182.

[68] *Ibid.*, p. 179.

[69] Perhaps the most laudatory review was David Laitin's "The Civic Culture at Thirty," *American Political Science Review* 89:1 (March 1995), pp. 168-173.

[70] Perhaps the greatest indicator of the importance of Putnam's findings, oddly enough, is that an entire issue of *Politics and Society* [24:1 (March 1996)]was dedicated to articles critical of *Making Democracy Work*. Ellis Goldberg ("Thinking About How Democracy Works") argues that differences between northern and southern Italy are best explained by the process of Italian state-building and the political domination and manipulation of the south by the north. Filippo Sabetti ("Path Dependency and Civic Culture: Some Lessons from Italy about Interpreting Social Experiments") contends that Putnam's interpretation of Italian history is misguided. Finally, Margaret Levi ("Social and Unsocial Capital: A Review Essay of Robert Putnam's *Making Democracy Work*") faults Putnam for not making explicit causal connections between civic association, social capital, and good government.

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justified, particularly on Putnam's haphazard use of history, it does not seem sufficient to reject Putnam's larger theoretical claim.[71] The question, nevertheless, is not how well Putnam explains democracy, but whether the causal logic of his model can be readily extended to explain economic phenomena. Putnam's rather compelling case falls apart, unfortunately, when applied to economic issues. Putnam portrays social capital as a general prerequisite for effective collective action, thus equally important for the efficient functioning of markets as it is for the efficient functioning of government. He cites the success of "industrial districts" made up of small, horizontally integrated firms of the so-called "third Italy" as evidence.[72] While this argument serves well in this instance (and has been used to explain the prosperity of other industrial areas)[73] its validity withers when applied cross-nationally and historically. How, after all, would one use the idea of social capital to explain the dynamism of the British economy in the 19th century? While one would certainly find evidence of social capital in Victorian Britain, equally one would find a nation riven by class and regional cleavages. The social capital argument, applied to questions of economic development, fits at best imperfectly. Putnam offers a needed palliative to interest-centered analyses by showing how the culturally-based perceptions of social actors shape their responses to institutional change. He falls short,

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[71] Levi's point about the poorly specified connection between membership in sport and social groups leading to a vibrant political community, and Sabetti's complaint about his interpretation of history, are both quite justified. Nonetheless, Levi's argument implies that the specific contextual factors on which Putnam rests his theory may not be valid, not that contextual factors are completely invalid. Criticisms of Putnam's use of history clearly hit the mark, but this calls for a more theoretically-determined historiography, not the rejection of historically-based theory. See Ian Lustick, "History, Historiography, and Political Science: Multiple Historical Records and the Problem of Selection Bias," *American Political Science Review* 90:3 (September 1996), pp. 605-618 for some guidelines to solving the historiography problem.

[72] Putnam, p. 160. The term "industrial district" refers to a region made up of numerous small firms that are horizontally integrated, as opposed to the vertical integration of many modern corporations. Since each firm contributes to only part of the production process through what is termed "flexible specialization", widespread cooperation all along the production chain is needed. The term "third Italy" is used to refer to the region to distinguish it from the traditional industrial areas of the north and the backward economies of the south.

[73] Saxenian, *Regional Advantage*.

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however, in placing all of his bets on the importance of social capital to the exclusion of other solutions.

A more precise extension of institutional analysis to the economic realm is represented by the "new institutional economics," or NIE. This school accepts the initial premises of neoclassical economics – it employs methodological individualism, sees economics as a theory of choice subject to constraints, accepts the scarcity-hence-competition postulate, and examines the importance of relative prices in establishing market equilibria.[74] Building on the insights of Coase elaborated above, the NIE rejects, on the other hand, the neoclassical portrait of frictionless markets. When there are costs to transacting, institutions matter. By placing institutions at the center of analysis, the NIE attempts to build both grand historical and middle-range theories that can explain divergent economic outcomes.

The NIE's most noted proponent is Nobel Laureate Douglass C. North, whose *Institutions, Institutional Change, and Economic Performance*[75] offers the clearest elaboration of the approach. His main concern is: Why do some economies consistently outperform others? Neoclassical economics, with its Darwinian view of economic structures, offers only a tautological answer. In reality, individuals are constrained by "bounded rationality" and preconceived motivations which may or may not lead them to economically efficient choices. Faced with the risks of opportunism on the part of other actors and the costs of obtaining information and protecting property rights, transaction costs increase. Transaction costs are thus the source of institutions, which give structure to everyday life.[76] "Institutions include any form of constraint that human beings devise to shape human interaction."[77] Institutions can be formal, such as state constitutions, or informal, such as culture.[78] The latter, the "mental models" through which individuals interpret the world, are especially

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[74] Douglass C. North, "NIE and Third World Development," in John Harriss, Janet Hunter and Colin M. Lewis, *The New Institutional Economics and Third World Development* (London: Routledge, 1995), p. 19.

[75] See f.n. 4.

[76] North, *Institutions, Institutional Change, and Economic Performance* , p. 27.

[77] *Ibid.*, p. 4.

[78] North sees both informal and formal institutions largely in functional terms. Both come into existence to solve coordination problems and facilitate exchange. See p. 41 on informal institutions, and p. 47 on formal institutions.

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important in that they imply that multiple equilibria (given similar constraints) can occur.[79] Institutions are thus the broad "rules of the game," which he distinguishes sharply from the "players" – the political, economic, social, etc., organizations that function within a given set of rules. Institutions, especially the structure of property rights,[80] along with traditional economic constraints (scarcity and technology), alter the opportunity set in which organizations pursue their objectives.[81]

How do institutions influence economic performance? If transaction costs are greater than zero, then institutions influence the allocation of resources by raising or lowering the costliness of transacting, which influences overall costs for firms (e.g., the legal expenses required by a firm to defend property rights in a particularly litigious society, like the U.S.). Whether this leads to positive or negative change is best viewed from the perspective of the firm. In the neoclassical perspective, the firm is perceived as a production function; total cost is the summation of various production (transformation) costs. By bringing transaction costs into the picture, North maintains total cost includes both transformation and transaction costs. This applies directly to questions of structural adjustment and economic growth, because transaction costs influence the efficiency of factor and product markets, and these in turn influence the extent to which advanced technology is likely to be employed by firms.[82] At the extreme, entrepreneurs are unlikely to make productive investments if they are not protected by the state from destruction or are subject to appropriation. At a more mundane level, a firm may think twice about purchasing a high-tech assembly

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[79] North, "NIE and Third World Development," p. 18.

[80] The existence of "efficient property rights" is crucial to North's model. Unfortunately, he never really defines what he means by "efficient property rights." Implicitly he falls back upon the neoclassical conception of equating efficiency with growth maximization growth. This may be useful for explaining extreme negative cases (i.e., the former Soviet Union) or making post hoc historical comparisons (e.g., the U.S. vs. Latin America in the 19th century), but it is a poor guide for specific policy recommendations.

[81] North also adds enforcement characteristics (that is, the extent to which the rules of the game are efficiently and neutrally enforced, mainly by the state) to the analytical mix.

[82] Technology, as a force of economic change in itself, is exogenous to North's framework. His model only explains the extent to which optimum technology is employed (or not) in different locales within, as it were, a given "technological paradigm."

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line if running it requires flexible, cooperative labor relations, and labor-management relations are poor. The constellation of institutional structures faced by economic actors influences a country's "adaptive efficiency" – its willingness and ability to make productivity-improving adjustments.[83] Institutions that discourage adaptation produce economic stagnation.

If institutions produce failure, why not just change institutions? Because institutional structures are path-dependent. The initial set of conditions faced by economic actors create externalities, economies of scope, and complementarites that lead to increasing returns for maximizing activity that conforms with the existing institutional matrix.[84] In general, institutions are stable, but this does not mean that they are efficient. The institutional framework will shape the direction of the acquisition of knowledge and skills, but that direction may be largely unproductive (e.g., the large rewards for clerical, rather than technical, knowledge in medieval Europe). For individual organizations, the existing institutional framework dictates the opportunities for maximizing behavior and creates complex interrelationships. This institutional complex may prove resistant to change more than its constituting parts would have done in isolation.[85] So when does change occur? Institutional change occurs when alterations in relative prices[86] lead economic actors to perceive that the payoffs for changing institutions exceeds the payoffs for maximizing behavior within existing constraints (which North premises on the relevant actors possessing "sufficient bargaining

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[83] North derives the idea of "adaptive efficiency" from Pavel Pelikan, "The Formation of Incentive Mechanisms in Different Economic Systems," in Stefan Hedlund (ed.), *Incentives and Economic Systems* (London: Croom Helm, 1987), pp. 27-56.

[84] Since "...information feedback is fragmentary at best, and transaction costs are significant, then the subjective models of actors modified both by very imperfect feedback and by ideology will shape the path." North, *Institutions, Institutional Change, and Economic Performance*, p. 95. Thus economically optimal (i.e., allocatively efficient) paths may be shunned. This point is just a restatement of the rent-seeking argument.

[85] Avner Greif, "Historical and Comparative Institutional Analysis," *The American Economic Review* 88:2 (May 1988), pp. 80-84.

[86] Some sources of changes in relative prices (e.g., economic shocks; technological change) are exogenous to North's model. Others, however, such as organizational alterations that improve the acquisition and dissemination of skills and knowledge, are endogenous. *Ibid.*, p. 84.

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strength").[87] Even when major changes occur, the net result is likely to be incremental, because changes in the formal (political, legal) rules do not alter informal (cultural, normative) constraints.[88] It is possible for societies to alter their institutional framework, but institutional stasis rather than institutional dynamism is the rule. Paths once set are difficult to reverse.

The key question for North and other institutional economists is whether a society's institutional matrix encourages efficient adaptation, or inefficient stagnation. They posit a causal chain of institutions (formal and informal) structuring incentives (via transaction costs) which shape actors' choices (by entrepreneurs) and determine economic outcomes (positive or negative). The model is still one of individual utility maximization, but with a vastly broadened conception of the sources of preferences and incentives. Poor economic performance can thus be explained by the persistence of institutional structures that discourage the process of continuous innovation necessary for economies to produce at their maximum potential.

At least as a broad heuristic, the NIE model offers a powerful analytical tool that corrects many of the failings of other institutionalist approaches. Going back to the question of explaining economic growth and performance, the NIE places the sources of market failure firmly within institutional structures. Market failure is clearly pervasive, but so is government failure. The NIE argues that neither a state-led nor market-led solution is invariably correct. "Rather, the task is to estimate the respective net change in transaction costs in comparison with anticipated allocative improvement, to find out whether policy should be favoring

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[87] North, like his neoclassical colleagues, thus sees individual entrepreneurs as the primary agents of change, and relative prices as the sources of change. He differs in that he filters these ideas through their institutional context. *Ibid.*, , p. 79.

[88] *Ibid.*, pp. 89-91; the same point can be made, as many historical institutionalist already have, regarding formal structures. New formal structures interact in a dialectical manner with existing structures, producing a "hybrid". One would therefore rarely expect a sudden, complete divergence from previous institutional paths.

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additional government intervention or further privatization." [89] Unlike the rational choice brand of institutionalism, moreover, the NIE self-consciously examines the formation of preferences. Finally, in contrast to Putnam's emphasis on social capital, the NIE provides a flexible framework that can easily be accommodated to various social and institutional matrixes.

That is not to say, however, that institutionalist approaches to economic change are without their flaws. Four problems readily come to mind. The first three focus on the theoretical conception of how social, political and economic structures are formed and alter the behavior of social actors. The final issue deals with the more practical question of the appropriate units of analysis. All of these problems weaken the ability of institutionalism to provide a credible and coherent framework for cross-national economic analysis as currently formulated.

The three theoretical problems relate to the source of institutions, the process through which they structure behavior, and the nature of that influence. The first problem is that institutionalism tends towards functionalism. Why are institutions formed? North contends that, "The major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction."[90] Putnam echoes this sentiment: "Institutions are devices for achieving *purposes*, not just for achieving *agreement*."[91] Institutions are thus conceived of as "problem solving" – as stable equilibria created for and functioning to achieve a particular purpose. But this portrayal, for one, assumes instrumental rationality among social actors in the creation and operation of institutions.[92] Institutions may be formed and supported for myriad reasons beyond rational self-interest – they may be guided by the "logic of appropriateness" (that a particular social order is good, or just, or simply the way things are done) rather than the "logic of

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[89] John Toye, "The New Institutional Economics and Its Implication for Development Theory," in Harriss, Hunter and Lewis, *The New Institutional Economics and Third World Development*, (London: Routledge, 1995) p. 58.

[90] North, *Institutions, Institutional Change, and Economic Performance*, p. 6.

[91] Putnam, p. 8.

[92] Toye, p. 65. Toye also warns against the dangers of finding a purpose for every last detail of existing social practice; p.57.

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consequentiality".[93] Furthermore, institutions may assume functions that were initially unintended (e.g., the Electoral College, intended as a barrier between the presidency and the popular vote, now serves largely to validate the popular vote), or are tangential to their primary function (e.g., Putnam's sports clubs creating norms of civic virtue). It is often argued that pervasive group consciousness among the Japanese gives them an economic advantage over individualistic Americans. Japanese collectivism and American individualism may alter economic outcomes, but one could hardly say that they developed for that purpose. Therefore, the view of institutions as functional should be rejected in favor of an inductive approach that interprets both the rationale and influence of institutions from the empirical material itself.[94]

Secondly, although the concept of transaction costs is central to institutionalist analysis (it is the "transmission belt" through which institutional structures alter behavior), it is more easily conceptualized than operationalized.[95] One can easily accept that friction in markets creates transaction costs that are variable with different organizational forms; it is much harder to specify just where transaction costs end and traditional production (factor) costs begin, weakening the middle link in the institutionalists' causal chain (institutions to transaction costs to economic outcomes). Many institutionalists skirt this issue by presenting a sweeping conception of transaction costs that blurs the

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[93] It would strain credulity, for example, to argue that a cruel practice like female circumcision is supported by the women it affects because they perceive it to be in their interest. Elinor Ostrom, "Rational Choice and Institutional Analysis: Towards Complementarity," *American Political Science Review* 85:1 (March 1991). North argues that institutions (macrosocial rules) may very well be guided by the "logic of appropriateness," thus leading to inefficiencies. Organizations, on the other hand, are only guided by the "logic of consequentiality" and are always efficient, *given* a certain institutional structure.

[94] This is also the position taken by Thelen and Steinmo, p. 12.

[95] It must be remembered that the concept of transaction costs was used initially by Coase and later Williamson to explain a microeconomic phenomenon (the formation of integrated firms) that was anomalous to orthodox economic theory. Even for such narrowly focused questions of economic governance, empirical analyses are difficult. Only later did North and others extrapolate a theory of macro-social change. For a review of empirical studies of transaction costs, see Scott E. Masten, "Empirical Research in Transaction Cost Economics: Challenges, Progress and Directions," in John Groenewegen (ed.), *Transaction Cost Economics and Beyond* (Boston: Kluwer Academic Publishers, 1996), pp. 43-64.

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line between transaction and production costs.[96] Relying on such a conception creates circular reasoning whereby almost all variance in economic performance is attributed to transaction-cost differentials. This is simply the market distortion logic of the neoclassicists in new guise, and it suffers from the same logical flaw. The problem is an extremely complex one, especially when examining institutions at a macrosocial level, and the problem of formulating a hard, quantifiable distinction between transformation and transaction costs may be largely insoluble.

It is not at all clear, furthermore, that institutions only alter transaction costs. Job training, for example, increases worker skills, leading to both wage rate and productivity increases, both of which directly impact production costs. The same example can equally be explained in transaction cost terms: the product being transacted is labor; the question is whether the firm has to pay extra in training in order make that transaction. That the same example can be portrayed as either a transaction or transformation cost shows that the transaction cost concept is poorly defined, yet it does not argue for an abandonment of the concept. The problem here is one of definition, not theoretical logic – incentive problems are ubiquitous, and whether we label these "transaction costs incentives," "production cost incentives," or generic "incentives" makes little difference from a theoretical standpoint.[97] A cost is a cost and the real questions are whether the incentives created by a given institutional matrix alters total cost; how the incentive structure changes opportunity costs for entrepreneurs, making certain investments profitable and others unattractive; and the cumulative result of such incentives for economic outcomes. As long as it is possible to make explicit connections between institutions, investment decisions, production decisions, and economic changes, then it does not really matter

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[96] Harold Demsetz, *Ownership, Control and the Firm*, Volume 1 (Oxford, UK: Basil Blackwell, 1988), pp. 149-150. According to North, the institutional matrix of an economy effects both transformation and transaction costs. How are transformation (production) costs altered? The technology employed by firms is determined by the efficiency of factor and product markets. Since factor markets involve exchange, there are transaction costs involved. In other words, institutions affect transformation costs by altering transaction costs for factor markets. North, *Institutions, Institutional Change, and Economic Performance*, pp. 64-65.

[97] Toye, p. 56.

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whether the term transaction costs or incentives is used. Moving from a sharp conception of transaction cost to a broader, fuzzier portrayal of general incentives does dilute one of the core concepts of institutionalism. But the practical difficulties of applying the transaction cost concept usually leads to its dilution anyway. The crucial point is that institutional structures alter incentive structures. Exactly how, and through what means, this occurs is better determined inductively than deductively. In short, it is better to stick with a practically useful, albeit fuzzy, conception of incentives than to insist on a sharply defined, but largely useless conception of transaction costs.

Third, appropriate institutional change has been raised to a central place in the institutionalist theory of development,[98] but institutionalists do not offer a well-developed theory of change, thus leading to a tendency towards determinism. North's theory of change (that economic actors will change institutions when they perceive that the payoffs for new institutions exceeds the current structure) implies the sort of natural selection that plagues neoclassical thinking. In addition, his theory is apolitical, even though his theory of change rests on actors possessing sufficient bargaining strength. Institutions are not just created to serve the public good; they are sometimes imposed by those with power on unwilling victims (e.g., slavery; the English Poor Laws). Mushtaq Khan argues that explaining institutional performance requires an understanding of the "political settlement" between various social forces within a state. Any institutional arrangement has costs and benefits that vary across social groups. It is, therefore, necessary to examine the *transition costs* (the political costs which potential losers from a proposed institutional change can impose on its proponents) in order to understand the process of institutional change.[99] Changing institutions is one potential solution to solving social dilemmas, and political

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[98] *Ibid.*, p. 61.

[99] Khan contends that clientelistic linkages between middle-class groups and the state explain the failure of state-led restructuring in Pakistan, while the state autonomy allowed similar policies to prosper in South Korea. Mushtaq Khan, "State Failures in Weak States: A Critique of New Institutionalist Explanations," in Harriss, Hunter and Lewis, *The New Institutionalism and Third World Development*, (London: Routledge, 1995), pp. 71-86.

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considerations should be central, not tangential, to the study of institutional change. In fairness, however, this is more of a problem for institutional economists than for their political science colleagues.

The flip-side of the lack of theory of change is a tendency towards determinism. Societies are seen as path-dependent. Social structures are "sticky," creating virtuous or vicious cycles over the long-term. The view of path dependency presented by both North and Putnam implies linearity. Once a society sets down a given path, change is unlikely to occur unless there are tectonic shifts in institutions. Putnam thus offers a far-from-sanguine view about the potential for successful democracy; if norms of civic community are not present, then little can be done. From a policy-making standpoint, this implies scant potential for positive economic change if the institutional matrix is unfavorable. Human agency is essentially eliminated from the equation. From a theoretical standpoint, such structural determinism may offer reasonable explanations for cross-cultural variation, but it cannot explain variation within a given context. Path dependence is an important and useful concept, but path dependence properly understood does not imply linear development or the complete subordination of human choice to the determinants of the socio-political structure. It implies rather that social context and history profoundly condition the choices that actors make, and alter the probabilities of certain choices being effective. (In fairness, North concurs with this position,[100] although Putnam is more of a determinist.) The question then becomes: given the constellation of social, political and economic institutions of country Y, what might be the appropriate policy to solve problem X? The challenge is not necessarily to alter the institutional structure, but to achieve certain goals *given* the institutional realities in which policies are being formulated. It is not to wish that southern Italians were more civic minded, necessarily; it is rather to attempt to come up with democratic structures that might have a reasonable chance of securing efficient and responsive government given the "un-civic" attitudes of the citizens in the region.

As to specific questions of economic adjustment, the institutional context shapes, but does not determine, the possibilities for policy

[100] North, *Institutions, Institutional Change, and Economic Performance*, p. 98.

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success by creating variable opportunity costs for different economic endeavors. The key question is whether this structure of incentives encourages socially productive or socially unproductive activity. Economic policy-makers can choose from a menu of policy options running along a continuum from pure laissez-faire to dirigiste intervention. In choosing among these options, the critical questions are whether the structure of social and institutional opportunity costs is largely conducive to adjustment through the chosen policy package, or whether an alternative would more likely succeed. It is not simply a matter of emulating the policies of other nations (which is the inherent policy prescription of both statist and free market arguments), *but of matching policies to a given institutional context in order to achieve certain goals*. Understanding the process of economic development and growth should not simply be the search for the "magic policy" that will produce prosperity in all places at all times. History does not support the existence of such a policy. Rather, both from an analytical and a practical standpoint, the goal should be to match policies appropriately to the given institutional matrix of a particular place at a particular time.

Three qualifications are needed. Obviously, for one, both policy-makers and policies are as much a part of the institutional context as anything else. The distinction made here between policies and context is a practical, analytical distinction, not an empirical or theoretical distinction. What this approach calls for is to "abstract out" one variable within the broader category of the institutional context (economic policies), and determine how changes in that variable interact with the rest of the social and economic system. In reality the interaction between policies and context is dynamically interactive; both change in an action-response-reaction pattern. Yet this just indicates a second problem: the institutional context (really, the factors that collectively form that context), is a variable, not a constant. Nevertheless, it can equally be said that many of these are relatively stable, following Stephen Krasner's model of "punctuated equilibrium": long periods of institutional stability punctuated by crises that lead to sudden institutional change.[101] Finally, policies

[101] Stephen D. Krasner, "Approaches to the State: Alternative Conceptions and Historical Dynamics," *Comparative Politics* 16:2 (January 1984), pp. 223-246.

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can not only attempt to achieve certain ends within a given contextual structure, but may also seek to alter the context directly. American antitrust legislation of the early 1900s specifically aimed to alter the industrial structure (reducing concentration) by busting the trusts. The intent is to alter the opportunity-set for later policies. Conceived in institutional terms, policy-makers have two possibilities for success: (1) formulate policies that seek to achieve their ends by conforming to the institutional context ; or (2) formulate policies that seek to alter the institutional context in such a way as to open new policy options down the road. The costs entailed by the two options may not be equal, however. Given path dependencies, institutional structures are difficult to alter, particularly because they create interests in support of their continuation which may raise the political costs of attempting to alter them. On the other hand, growth-inhibiting institutional structures may be so heavily entrenched within society that it is necessary to radically alter them to achieve the desired ends.[102] The exact costs and benefits of different options are, of course, context-specific, but there is thus an inherent benefit in terms of lower political and economic opportunity costs to policies that conform with, rather than attempt to transform, a nation's institutional context. The fundamental policy implication is that economies are not interchangeable, and that policies that are successful in one context may not be in another. *Policies are more likely to achieve success to the extent that the social, political and economic institutional structures create behaviors that mirror the behavioral assumptions of the policy.*

This being said, it is important to specify just what exactly should be analyzed, which raises the final question of the appropriate unit of analysis. Most institutionalists agree that both the *rules of the game* (formal and informal) and economic, political and social *organizations* should be incorporated in the analysis. Beyond that, the relevant literature suffers from numerous contradictions as to what is the appropriate unit of analysis (What exactly do institutionalists mean by "institutions"?) or level of analysis (Are the crucial institutions to be found at the microeconomic level? At the sectoral level? In

[102] The Thatcherite assault on Britain's labor unions could be considered an example of this approach.

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national economic institutions?). North defines institutions as the macro-level rules of the game, thus distinguishing the players (organizations) from the rules (institutions). Putnam (and most other institutionalists) calls institutions what North refers to as organizations, drawing the analytical focus both to the players and to intermediate and lower levels of analysis. In reality, the appropriateness of a given level of analysis is partly an issue of the research-question at hand. North's macro-level focus can do well at explaining differential outcomes when high-level rules vary, but not when they are similar. Yet focusing solely on intermediate level institutions, as some institutionalists advocate,[103] is equally problematic. Putnam's thesis, after all, rests on the interaction of intermediate institutional structures with the larger cultural context. Lacking guidance as to the appropriate unit of analysis, a bad tendency arises among researchers to arbitrarily pick "the key institution" without examining the potential influence of others. From a policy standpoint, this may also provide biased analyses since the costs and benefits of alternatives are not thoroughly explored.[104] It is important – at least for questions of national economic performance – to examine institutions at the national, intermediate and micro levels rather than to assume, *a priori*, the location of relevant institutions. Further, apropos Putnam, the dynamic interaction between institutions at different levels can then be examined, a point to which we will return below.

Problems also arise in drawing sharp distinctions between institutions (rules) and organizations (players). For one, it is difficult to neatly categorize the real world as such. Is the family an institution or an organization? In reality, the family is both a social ideal and a physical unit. The same could be said about a democratic legislature or the Catholic Church. In short, rules and players overlap in the real world. Nor is there necessarily analytical benefit to making this distinction. Alexander Wendt makes a strong argument that the structures of interaction are largely derivative of the actors' definition

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[103] Thelen and Steinmo, p. 11.

[104] Robert Bates, "Social Dilemmas and Rational Individuals: An Assessment of the New Institutionalism," in Harriss, Hunter, and Lewis, *The New Institutionalism and Third World Development*, (London: Routledge, 1995), pp. 39-40.

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of those rules, making it analytically unsound to differentiate sharply between agents and structure.[105] We cannot separate the players from the context because the players are part of the context. It needs to be recognized that sharp distinctions cannot be drawn between the ideas that guide interaction and the organizations that incorporate those ideas. It is necessary to formulate an analytical structure that accepts the sloppiness of the real world.

The simplest way to accomplish this would be by taking a rather broad view of just what constitutes an "institution." However, this would merely replace the confusion of competing definitions with a sophistic non-definition – anything and everything would thus be labeled an institution. Some happy medium needs to be struck between such sweeping inclusiveness and the formulation of an overly constricted framework. In this respect it is particularly unfortunate that this school of analysis has been labeled "institutionalism," since at its most powerful, it incorporates numerous factors of the social, political and economic context that structure the process of decision-making, not just formal institutions. This illustrates the need for an integrated approach that analyzes the broad social context of economic decision-making rather than an institutional analysis per se.

The best way forward is to build on the framework advanced by Kathleen Thelen and Sven Steinmo, which emphasizes the interaction of interests ideas, and institutions. *Interests* means the shared attitudes and goals of social actors. Interests are, of course, usually represented by interest groups. As formal organizations, interest groups are the institutional manifestation of an interest. Thus labor and business are interests; the Teamsters and The National Union of Manufactures are institutions. The inclusion of interests in the analysis is particularly useful in that it allows questions of relative political power of different social groups to be addressed directly, rather than simply inferred from the social structure.

Ideas,[106] as formulated here, encompass the various mental

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[105] Alexander Wendt, "The Agent-Structure Problem in International Relations," *International Organization* (Spring 1992), pp. 391-425.

[106] The concept of ideas, as used here, is limited to informal rules and norms. Those that have been in some way formalized should be treated as institutions. For example, the ethical principle that murder is wrong is an idea; the structures of laws and law enforcement and judicial personnel required to uphold that principle would be considered

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models that serve to condition actors' behavior. Ideas come in many more or less enduring forms, including culture, ideology, or Peter Hall's more narrowly drawn policy paradigms.[107] *Culture* can be defined as a system of attitudes, values and knowledge towards the political, economic and social system formulated by a given society through both societal and individual experiences that is relatively enduring, but not immutable. *Ideology* is an interpretation of one's environment and prescriptions as to how that environment should be structured. Conceived as such, culture differs from ideology in that it is more enduring; it is transmitted primarily through the process of socialization; and culture implies commonly held beliefs that are widely shared among individuals within a clearly defined group. *Policy paradigms* are overarching ideas about how problems are to be perceived, which goals might be attained through policy, and the techniques that will likely achieve these goals. In short, policy paradigms formulate cause and effect relationships between policies and outcomes. The inclusion of ideas into institutionalist analysis has been criticized by Mark Blyth as a *deus ex machina* used to account for residual variance.[108] But this is only true if the weight of causation is *a priori* tilted towards (formal) institutional structures rather than ideas, or if ideas are only considered salient to the extent that they alter institutional structures. These problems are avoided if one gives ideas and institutions equal (potential) causal weight and conceives of ideas as influential in and of themselves.

Explicitly including interest and ideas in "institutionalist" analysis allows us to limit our definition of *institutions* to the sensible and manageable idea of *formal* organizations, rules, compliance procedures and practices.[109] Institutions are important in shaping actors' goals and strategies, and structuring relations of cooperation and conflict, thus structuring the realm of possible – or, at least, feasible – choices.

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institutions.

[107] Peter A. Hall, "Policy Paradigms, Social Learning and the State," *Comparative Politics* 25 (April 1993), pp. 275-296.

[108] Mark M. Blyth, "'Any More Bright Ideas?': The Ideational Turn of Comparative Political Economy," *Comparative Politics* 30 (January 1997), pp. 229-250.

[109] This definition was originally used by Hall in *Governing the Economy*, p. 19.

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Obviously, the above are not discrete conceptual categories. There is a significant amount of overlap between these concepts, and many elements of the social structure cannot be placed neatly in one or the other category. A labor union, after all, is obviously a (formal) institution, but it also represents an interest (workers) and embodies an idea (collective bargaining). Reality rarely accommodates the social scientist by sorting itself in an orderly fashion. So are we to label our labor union an interest, an idea, or an institution? In a sense, all of the above. As long as the analysis accounts for the political and economic interests of workers, the structure of their union organization, the prevalence or nature of the idea of collective bargaining, and how these influence the potential impact of different economic policies within a given national context, it does not so much matter under which heading we place "unions". More importantly, it separates the concept into its component parts (e.g., the formal organizational structure, ideas of worker solidarity and collective bargaining, etc.) which allows the analyst a greater ability to evaluate the relative causal significance of each element.

Pegging the analysis in terms of interests, ideas, and institutions thus allows the researcher to capture the numerous potential-structuring influences on social actors' decision-making while offering a manageable form of categorization. Three crucial points to note are, first of all, it is not sufficient to identify these factors individually, but to explore how they interact. Broad questions of comparative national economic development require a holistic approach, examining how the national context *as a whole* alters economic outcomes. This can be contrasted with the middle-range theories of the historical institutionalists. On the other hand, this approach should not be confused with either the structural determinism of Marxist analyses or the imputed functionalism of either rational choice institutionalism or institutional economics. The framework suggested here accords with the historical institutionalists' call for an inductive approach to comparative political research. One must examine the influence of all elements of institutional context on how economic policy is translated into economic outcomes. But this framework does not deduce any particular function for particular elements of the institutional context, nor does it imply either particular political or economic interests or power from the institutional structure. These factors are important, but they must be

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examined, not inferred. (As such, it is clearly intended as a framework for analysis, not as a theory.) Equally, however, such inference must explore how any given contextual factor *interacts* with other factors. For example, we cannot truly understand the functioning of American unions – or, more importantly, understand how they might respond to something like Japanese-style lifetime employment schemes – devoid from their place in the larger American political economy.

Secondly, as argued above, path dependence is treated seriously, but path dependence properly understood: as *structuring choices*, making certain options more or less feasible, not as determining outcomes. Finally, in order to grasp how different elements dynamically interact to structure a national economic context, data must be included from different levels of analysis – macro (national), intermediate (regional), and micro (local). This differs from Thelen and Steinmo, who argue for an intermediate level focus.[110]

In summary, the key point of this essay is that the national institutional context is a crucial intervening variable through which economic policy must flow. The institutional context, by changing the opportunity costs of alternative paths of economic adjustment, alters the probability of different economic policies producing growth and development. Furthermore, since the elements of the national institutional context interact dynamically, policies formulated in one context may, when placed in another, produce behavior among social actors that is economically negative or, at least, not growth-enhancing. The appropriate path to adjustment can only be determined by an examination of the institutional context. Table I presents a menu of factors that are potentially relevant for questions of economic adjustment. But this list is not exhaustive. Depending on the nature of the research question, for example, international level variables may also need to be included. (However, it is often the case that we want to explain differences in economic performance between states facing relatively similar international constraints and opportunities. As such, the international context can be taken as more of a "given" that affects all of the states under comparison.)

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[110] Thelen and Steinmo, p. 11.

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TABLE I: Key Elements of the Institutional Context

	Institutions	Interests	Ideas
National Level	Representative and Executive Structures Economic Policy-Making Structures (Peak) Business Organizations (Peak) Labor Organizations	State Autonomy from Civil Society Division of Labor and Capital Partisan Divisions/ Mobilization Capability Ethnic/Racial Divisions	Dominant Policy Paradigm View of the State Division between Public/Private Sectors Pro-Business v. Pro-Market State
Inter-mediate Level	Union Organization Industry Organization Regulatory Structure Bureucratic Capability	Sectoral Interests Level of Interfirm Cooperation Specific Union Interests and Mobilization Capability	View of Interfirm Collaboration Cooperative/ Conflictual Unions Discriminatory Policies Accepted by the State
Micro Level	Firm Structure Local Union Organization Local Government and Regulatory Bodies Educational and Vocational System	Labor Shopfloor Interest Business Shopfloor Interests and Ability to Enforce Local Government Interest and Capacity to Act Authoritatively	Workers View of Rights and Privileges Management Ethos Entrepreneurial Spirit Local Government's Role in Economic Development

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Institutions as Intervening Variables: An Illustrative Example

Two obvious potential criticisms of this approach are that it is overly cumbersome, and that it would yield similar conclusions as standard institutionalist analysis. These criticisms can be addressed through a brief (and, of necessity, relatively superficial) application of the framework. By re-examining Peter Hall's classic institutionalist analysis of British and French economic development, *Governing the Economy*, it can first be shown that this approach is not overly cumbersome. Moreover, some simple counterfactual analysis will indicate that an examination of the broad institutional context calls into question Hall's original findings regarding Britain.

Hall seeks to explain the relatively poor performance of Britain compared to France in the postwar era by reference to the key elements of each state's political economy and how these shaped the ability of each to successfully restructure its economy. Five factors are key for Hall: (1) the organization of labor; (2) the organization of capital; (3) the organization of the state; (4) the position of the nation within the international economy; and (5) the organization of the political system. [111] However, the latter two are given short shrift; the organization of labor, capital and the state are used to tell the bulk of the story.

In France, finance capital maintained considerable leverage and was able to exercise significant influence over the investment decisions of industrial firms due to their heavy reliance on long-term debt for finance. At the same time, the state – specifically, the Ministry of Finance – exercised considerable control over the banking sector through their control of credit and the money supply. This allowed the Ministry of Finance to closely supervise French industrial policy, which was run efficiently and effectively because of a highly talented, elite civil service dominated by graduates of the *Ecole Nationale d'Administration* (ENA). Moreover, the tools of the state were not only in capable, but also relatively autonomous hands, given the divided and weak status of the French labor movement. The state was thus able to use price controls, without much political cost, in order to stiffen employer's resolve in resisting wage demands. All of

[111] Hall, *Governing the Economy*, p. 232.

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this allowed French economic policy to focus on stimulating investment above all else. This was done through the rapid expansion of demand via spending; the expansion of cheap, subsidized credit for industrial investment; and devaluation of the currency to ensure international price competitiveness. Thus the French "strategic state" was able to effectively pursue an activist industrial policy, expanding industrial investment, and securing the basis for high and stable growth. [112]

In Britain, the possibility of a coherent industrial policy was limited by the lack of a central economic ministry. Fiscal policy fell under the Treasury's purview, while the Bank of England maintained primary responsibility for monetary policy. Nor was the organization of capital favorable to coordinated reorganization. Britain was (and is) notable for a large financial sector with a distinctly international orientation. Their continued prosperity thus required that the value of the pound be maintained. Moreover, British industry generated most of its investment funds internally through retained profits or through the stock market. Finance and industrial capital thus defined their interests separately. The influence of the City produced the recurrence of "stop-go" cycles of deflation and reflation brought on by the need to maintain a strong pound.[113] The volatility of the economy discouraged industrial investment which might have improved Britain's poor productivity performance and made British exports less price competitive.

The organization of British labor further militated against a coordinated restructuring plan. Political influence was assured through their formal affiliation with the Labour Party. In addition, the labor movement possessed a national voice in the form of the Trades Union Congress. Nonetheless, the TUC was never more than a loss confederation of member unions, and national labor leaders possessed few powers with which to exercise effective control. This frequently allowed labor policy to be set by (often militant) shop stewards. In addition, unions were organized along craft lines rather

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[112] *Ibid.*, pp. 242-248.

[113] Expansionary policy had the result of sucking imports into the economy, which put pressure on the balance of payments and an outflow of foreign exchange reserves. Rather than devalue, Britain time and again deflated the economy in order to stabilize the balance of payments.

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than industry-wide unions. This meant that any given firm might have to satisfy the demands of dozens of unions, many of whom were keen to defend the prerogatives of their clearly defined job descriptions. Such a situation does not bode well for productive restructuring. The net result was that British industries failed to make productivity-improving investments and their international industrial competitiveness foundered. The government failed to formulate a coordinated industrial policy, relying instead on tripartite bargaining in order to suppress wage demands and prices. Given the weak links of the labor movement, this policy struggled along for years until finally collapsing following the widespread strikes of the "Winter of Discontent" of 1979-80.

In summary, Hall writes:

> The British state simply lacked the means with which to enforce an active policy of sectoral reorganization, even if it could have formulated one....Power over the direction of economic policy remained with a Treasury that had little industrial experience or explicit responsibility for British industry. Without a powerful apparatus committed to sectoral planning in Whitehall, the British state proved attentive to sectoral problems only in crisis situations. Initiative in this area remained at the political level where concerns naturally focused on the short-term alleviation of unemployment rather than the long-term reallocation of investment toward growth sectors of industry.[114]

The conclusion to be derived from these two cases is patently clear: France prospered because it was graced with a capable, autonomous bureaucratic elite, armed with exceptional tools of sectoral intervention with which to guide industrial investment; Britain stagnated because the state was impotent in the realm of industrial policy.

What, however, is the policy lesson to be drawn? What could

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[114] Hall, *Governing the Economy*, p. 252

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Britain have done differently to avoid stagnation? Although Hall avoids drawing hard conclusions, the thrust of his analysis implies that the capability of the state for sectoral intervention is the determinant variable. The logical counterfactual question then becomes: What if Britain *had* possessed more coherent and finely honed industrial policy instruments? Would this have secured industrial reorganization and improved economic performance? The implication from Hall's analysis is that it would have. But a focus on the overall institutional context calls that conclusion into question.

Table II outlines the key elements of British political economy in the postwar era (pre-Thatcher). Let us suppose for one moment that Britain possessed the very powers that Hall praises in the French state: the vesting of responsibility for fiscal, monetary and industrial policy with the Treasury, and the establishment of extensive state-controlled credit institutions. Would this change have been sufficient? A quick examination of the remainder of Table II suggests not. Most of the structural constraints to industrial reorganization cited by Hall would still remain: a significant financial sector requiring a strong pound; conflictual labor relations; an ideological opposition to discriminatory sectoral intervention; a generalist civil service; poorly trained managers, etc. Look, for example, at the organization of labor in Britain at the time. Their craft basis, hostility to management, weak enforcement ability from the national to the local level, and direct political influence through the Labour Party all suggest that they would have both an interest in and political influence to resist any significant state-sponsored reorganization of production. Indeed, given the consensus for maintaining full employment, the likelihood is that subsidized investment would merely be channeled to lame duck industries in order to maintain employment in depressed areas. Yet these conclusions are hardly original; this is a relatively fair representation of what happened in terms of incomes and industrial policy in Britain in the 1970s at a much lower level of state intervention.

Hall's institutionalist argument certainly does well at highlighting the structural constraints faced by British policy-makers, but because the policy prescription thus produced is strikingly similar to purely policy-oriented studies: emulate the policies of the chosen success story. Granted, Hall would certainly recognize that other elements of the political economy would influence the ability of the state to

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TABLE II: Britain's Institutional Context in the Postwar Era

	Institutions	Interests	Ideas
National Level	Strong Executive Treasury Focused on Defending Pound Weak Pro-Industry Conservatives; Labour with Formal Unions Ties CBI without City; TUC with Weak Authority	Internationally-Oriented Finance (the City); Domestically-Oriented Industry (Internationlly Uncompetitive) Two-Party System with Regularly Alternation of Government Class Cleavages Regional Cleavages	Keynesianism with Full Employment and Social Welfare Emphasis Limited Industrial Reorganization; Business Opposes State Intervention Labor and Capital Viewed as Antithetical
Inter-mediate Level	Generalist Bureacracy Nationalization of Industry No Regional Governments Craft Unions	Finance Demands Strong Pound Nationalized Industries with Political Influence Little Cross-Ownership Unions Defend Wage Differentials	General Pro-Market Orientation Conflictual Labor Relations Cartelization Discouraged
Micro Level	Weak Local Govt. Poor Firm Structure with Few Professionally Trained Managers Shop Steward Control Poor Education System including Vocational	Equity Financing w/ High Profit Margins (produces "Short-Termism") Managerial Weakness Unions Defending Narrowly-Defined Job Categories	Workers Rights and Privileges Defined by Craft, not Industry or Firm Weak Innovative Ethos Local Authorities as Social Provider Only (funded by Central Government)

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effectively implement sectoral reorganization, and that alterations in the institutional context (e.g., giving industrial reorganization priority over full employment) would be required for an efficient and effective industrial policy. By examining the entire institutional context, however, it becomes clear that this would require not minor, but revolutionary, reorganization of the institutional context in order to work. Revolutions certainly do occur; the reforms implemented under Thatcher, particularly changes in labor union regulation, are often portrayed as revolutionary. But revolutions are costly. What the above analysis highlights is that the political and economic opportunity costs that would have been engendered by the British state in attempting to implement a coherent national industrial policy, given the extent of reform that this would have entailed, militated against the attempt. Plain and simply, the British political economy of the postwar era was not well suited for French style *dirigism*. This does not necessarily imply the opposite: that the extent to which the British state *did* intervene in the economy through nationalized industries and relatively meek industrial policy structures is the culprit in British decline. But it does imply that going further down that road would not likely have solved their problems.

Admittedly, it is much easier to state the negative case than to formulate a positive solution. A serious effort at this can not be attempted here. Nonetheless, the guidance offered by an emphasis on the broader institutional context points to policies that attempt to achieve positive economic restructuring within the confines of the given institutional structure where possible, and seeks to alter the context only where necessary and feasible.

Globalization and National Institutions:
Neoliberal and Organized Market Economies

One of the most salient questions of current political economy scholarship is the nature and influence of processes of globalization on national economic growth. Globalization, in its economic guise, refers primarily to a situation in which, "...transactions across the borders of nation-states increase in importance relative to those within nation-states; and whereby national boundaries cease to be a

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significant impediment to the movement of goods and services." [115] It is the latter that is most significant, manifest mainly through capital mobility. Although this process is partially driven by (and, thus, potentially controlled by) state policies (e.g., ending restrictions on capital controls), David M. Andrews makes the point the changes in technology (in the form of advanced information technology) and the practices of major financial firms (e.g., the development of "Eurodollar" markets outside of the normal purview of national authorities) have also driven the process. As such, globalization is a structural feature of the international political economy beyond the control of any individual state.[116] Globalization is imputed to alter national economic policy-making in two key ways. First, it is argued that globalization will lead to convergence in forms of organization among both private and public institutions.[117] Numerous authors, however, have documented that differences in national organization of both private multinational firms[118] and governmental structures[119] remain. Indeed, given the thrust of this paper, this is hardly surprising. The second influence of globalization is to decrease the state autonomy over national economic policy. This analysis has primarily focused on monetary and exchange rate policies, but the logic would equally hold for microeconomic policies, particularly

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[115] Wyn Grant, "Perspectives on Globalization and Economic Coordination," in J. Rogers Hollingsworth and Robert Boyer (eds.), *Contemporary Capitalism: The Embeddedness of Institutions* (Cambridge, UK: Cambridge University Press, 1997), p. 320.

[116] David M. Andrews, "Capital Mobility and State Autonomy: Toward a Structural theory of International Monetary Relations," *International Studies Quarterly* 38:2 (June 1994), pp. 195-218.

[117] For an extensive analysis of the "convergence hypothesis", see Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism* (Ithaca, NY: Cornell University Press), 1996.

[118] Louis W. Pauly and Simon Reich, "National Structures and Multinational Behavior: Enduring Differences in the Age of Globalization," *International Organization* 51:1 (Winter 1997), pp. 1-30.

[119] See Robert Boyer, "The Convergence Hypothesis Revisited: Globalization but Still the Century of Nations" and Robert Wade, "Globalization and Its Limits: Reports of the Death of the National Economy are Greatly Exaggerated" in Berger and Dore, *National Diversity and Global Capitalism*, pp. 29-88.

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those governing labor markets.[120] The current inability of Russia to make credible market-based reforms and the flight of capital from Russia, putting extreme pressure on the value of the ruble, is an illustration of this point. The issue here is not so much one of state sovereignty; Russia can organize its economic system as it sees fit, including even a return to a command economy. Cuba and North Korea, after all, remain stubbornly isolated from the global economy despite ostensibly irresistible global market forces. The key point is that the processes of globalization have vastly increased the *economic costs* (in terms of net national wealth) of states pursuing policies that are perceived negatively by transnational investors and/or decrease the productivity of domestically invested capital.

Drawing the discussion back to national economic structures, given that all advanced industrial economies face the same global forces, the question arises why have the economies of the U.S. and Britain flourished in the late 1990s, while double-digit unemployment or stagnant growth reigns in France, Germany and Japan? Given that the longer-term record of these economies has been good, why are these problems arising now? In simple terms, the argument here is that political-economic institutional structures of these states, as a whole, are poorly suited to efficient production within an increasingly globalized economic structure. The political economies of these states are geared (although with institutional variations) to achieving the *coordination* of economic activity under state guidance, albeit within a broadly competitive structure (as such, they are generally referred to as "organized market economies"). In contrast, both the United States and Great Britain went through significant periods of neoliberal economic reforms under Reagan and Thatcher during the 1980s – reforms that have been truly embedded in the political economy through their acceptance by the left-leaning governments that followed. The cumulative process of deregulation, labor market

[120] Lewis et al. make the point that it is not capital mobility per se that is driving this process, but that capital mobility is increasingly serving to disconnect the performance of the monetary and real economies. Since the primary means through which the state can influence real economic growth is through monetary measures (e.g., interests rates and foreign exchange rates), this serves to dilute state sovereignty over the economy. See Mark Lewis, Robert Fitzgerald and Charles Harvey, *The Growth of Nations: Culture, Competitiveness and the Problem of Globalization* (Bristol, UK: Bristol Academic Press, 1996), p. 159.

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reform, and a general withdrawal of the state from economic activity has ensured that the prime imperatives for firms within these economies have been to be competitive and *adaptable*.

But how does this help us explain the relative reversal of economic fortunes between the neoliberal and organized market economies? Numerous authors, after all, contend that this should not happen; that states that effectively balance cooperation and competition are *always* better suited to adaptive behavior to achieve stable growth.[121] A more sophisticated exposition of this perspective is presented by J.Rogers Hollingsworth and Robert Boyer. They argue that there are multiple potential institutional configurations for economic governance in advanced capitalist economies (a clear rejection of the convergence hypothesis), each of which has its own particular failings, and none of which is inherently superior to the other in terms of performance.[122] Yet this merely begs the question of why, over time, different national economic institutional structures perform more or less well. Similar to the arguments above calling for an appropriate match between economic institutions and policies, the answer to this question lies in the inappropriate match between national political-economic structures and global economic forces.

By saying that state autonomy has been reduced, this really means that the state can no longer costlessly insert themselves between the gales of global market forces and the individual economic actors in their polity. This means that increasing globalization shifts the responsibility for economic adjustment away from the state and down to individual firms.[123] The problem for organized market economies is that these lower-level institutions (at the intermediate and micro levels of my framework) are not geared

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[121] For example, Alexander Hicks and Lane Kenworthy, "Cooperation and Political Economic Performance in Affluent Democratic Capitalism, *American Journal of Sociology* 103:6 (May 1998), pp. 1631-1672. See also Lane Kenworthy, *In Search of National Economic Success* (Thousand Oaks, CA: Sage) 1995.

[122] J. Rogers Hollingsworth and Robert Boyer, "Coordination of Economic Actors and Social Systems of Production," in J. Rogers Hollingsworth and Robert Boyer (eds.), *Contemporary Capitalism: The Embeddedness of Institutions* (Cambridge, UK: Cambridge University Press, 1997), pp. 1-48.

[123] In a sense this is simply saying that globalization pushes the real world closer to the neoclassical model of an open, competitive market.

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toward independent adjustment. The whole thrust of the neoliberal reform program was to expose firms and workers to competition within an unfettered market structure and let them sink or swim as they may. Thus American and British firms and workers are more attuned to and more accepting of the idea that the responsibility for economic adjustment rests with them rather than the state. The net result is flexible labor and capital markets and, perhaps most importantly, a widely accepted mentality among economic actors that international market forces must be accommodated. The ability of the state to coordinate adjustment has been sharply attenuated (via technological change and capital mobility), but this has not reduced economic growth because actors at lower levels are better able to adjust their activity without any coordinating institutions.

The situation in the organized market economies is just the opposite. During much of the postwar era, the state was effectively able to insulate domestic economic actors from the full rigors of international economic forces through assorted industrial policies, trade protections and extensive social welfare structures. This allowed these states the opportunity to coordinate investment and direct it to high-growth industries. However, political, economic and technological changes make state attempts to insulate economic actors from global market changes much more costly (via reduced growth), thus pushing the responsibility of economic adjustment on to lower-level actors. The lower-level institutional structures of these states, unfortunately, are poorly suited to uncoordinated adjustment. Labor markets, given either extensive social welfare structures or embedded principles of lifetime employment, are very rigid. The entrenched, often statutory role of labor in the decision-making process bodes against radical restructuring, given that it would likely lead to reduced benefits, if not reduced wages. Industrial reorganization is similarly hampered by relatively hierarchical and interconnected structures (*keiretsu* in Japan, cross-company share holding by large financial banks in Germany, etc.), which may hinder the relatively free-wheeling trial-and-error experimentation needed to succeed in cutting-edge industries (e.g., computer software). While this system may have worked well in a period of primarily mass production firms, the complexity and pace of economic change in the technology-driven, post-Fordist economic era makes it difficult for any single organization to effectively coordinate adjustment cross a

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wide range of industries. The political system, moreover, is relatively hamstrung, because serious talk of major structural reform is political suicide. There simply is no serious discussion of economic reform in either Japan or Germany (the 1998 contest between Gerhard Schröder and Helmut Kohl focused much more on leadership ability than detailed economic plans)[124], and the French response to continued high unemployment, rather than attempting to loosen their exceptionally rigid labor markets, has been to reduce the workweek from 38 to 35 hours – without, of course, any reduction in pay. Whether this will acutely reduce unemployment while maintaining national output is, to say the least, doubtful. Indeed, what may be the greatest hindrance to effective structural change in these countries is not the form economic institutions take per se, but a generalized mentality that rejects the principle that free or uncoordinated markets produce efficient outcomes. In essence, the *need* for structural reform is rejected. In sum, then, the political-economic institutional structures of the organized market economies are not efficiently adaptive to the demands of a high-tech-oriented global economy in which capital is highly mobile.[125]

It would be going too far to say that the above simply supports the widespread acceptance of liberal orthodoxy. After all, the fundamental point of this essay is that policy must be adapted to national circumstances in order to effectively address global change. However, there seems a good *prima facie* case that the institutional structures of the organized market economies, if unreformed, will prove a hindrance to growth over the long-term. Yet this point is only made clear by adopting an explicitly institutional approach that

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[124] See, for example, *The Economist*, July 25, 1998, p. 47.

[125] This position is hardly accepted orthodoxy. Peter Hall recently argued that the high levels of unemployment in the organized market economies of Europe is the result of lower aggregate demand (exacerbated by retrenchment to more conservative monetary policies in preparation for a single European currency) rather than institutional rigidities. However, this argument applies most weakly to the most important case: Germany. Monetary policies of states entering the EMU have largely been geared towards accommodating traditionally conservative German monetary policy, but German monetary policy is largely unchanged over time. As such, it cannot be used to explain increased unemployment. See Peter Hall, "Organized Market Economies and Unemployment in Europe: Is It Finally Time to Accept the Liberal Orthodoxy?" Paper presented at the Eleventh International Conference of Europeanists, Baltimore, MD, February 26-28, 1998.

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examines the operations of these economies in their full national and international context.

Conclusions

It has been argued that the policy-oriented political economy literature offers little theoretical or practical guidance, except in an ad hoc and contingent way, for understanding questions of economic growth and development consistently across space and time. Institutionalist authors have made significant strides in understanding how pre-existing structural conditions shape the choices faced by economic policy-makers. The conceptual and operational shortcomings of this approach as currently formulated, nonetheless, limit its analytical utility. Much of this literature is overly deterministic; an institutional context that is not adaptively efficient must either undergo radical transformation or stagnate. This is a rather poor guide for policy construction. A revision of the institutionalist framework has been offered that examines the broad institutional context, conceived of as interest, ideas and institutions manifested at the national, intermediate and micro levels of analysis. The institutional context, by altering the opportunity costs of alternative paths of economic adjustment, alters the probability of different economic policies producing growth and development. This line of analysis implies that the solution to problems of growth and development are neither free market or statist policies per se, but rather implementing economic policies that are likely to increase the nation's productive potential *given* the institutional context. The fundamental point is that economies are not interchangeable and policies that are successful in one context may not be in another. Policies are more likely to achieve success to the extent that the social, political and economic institutional structures create behaviors that mirror the behavioral assumptions of the policy. Policy-makers can, of course, attempt to alter the context and open up paths to new policies. The political and economic opportunity costs of formulating *policies that conform with a nation's institutional context*, however, are likely to be much lower than attempts at radical social reconstruction. Finally, this perspective equally shows that institutional structures are more or less adaptive to the changes brought about by increasing globalization. This helps explain the current divergence in

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performance between organized market economies and neoliberal states.

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A Critique of the Central Concepts in Free-Trade Theory

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The major concepts that underlie the "free trade" ideology which is so compelling in the world today are embraced by many proponents of the market economy as a closed philosophic system. When each concept is examined critically, however, it becomes apparent that it contains only an important part-truth. One of the central concepts is fallacious altogether. If a market economy is best to be adapted to future economic conditions, which are bound to involve much downsizing and economic displacement, the theory of the market needs to placed on a much sounder footing.

Key Words: Free trade, economic concepts, the act of exchange, wages and productivity, optimum allocation of resources, property rights, consumer sovereignty, Henry George, Friedrich List, comparative advantage, purchasing power, protectionist theory, protectionism.

It is possible to be fundamentally friendly, as this author is, toward the classical liberal theory of an individualistic free society and yet to see that many of its thinkers make the philosophy intellectually insufficient when they formulate it as a closed ideological system. This insularity, which has long cut free-market concepts off from critical self-examination, is especially descriptive of the currently popular *laissez-faire* global free-trade position.

Several of classical liberalism's core ideas involve subtleties that classical liberals, long forced on the defensive by the world Left, have not explored. Those subtleties show that the ideas are neither as correct nor as definitive as the advocates of the closed system consider them to be. By the time we have completed our analysis, it will be apparent that the pure *laissez-faire* model of classical liberalism is sufficiently unsound that erstwhile supporters of "free trade" should not feel themselves untrue to their own philosophy if they choose not to adhere strictly to it under the economic conditions of the future. In a world where the globalization of trade and the rapid development of non-labor-intensive technology point toward a massive displacement of workers and polarization of incomes in the foreseeable future, economic theory must be free to pursue a sounder theory. Old shibboleths will no longer suffice. No one needs to

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realize this more than the supporters of a free market themselves.

This article won't undertake to describe the changes in technology and work that are coming; those are vast subjects in themselves. We will limit the present discussion to a review of several of the pivotal concepts about a market economy and in the "free trade" position to assess their soundness.

INVALID OBJECTIONS

First, it is well to notice that there are major, long-standing criticisms of the market economy that are *not* valid. Later, when we see problems with much of the theory, we shouldn't be understood as endorsing those invalid criticisms. It will enhance conceptual clarity to include a discussion of those here, so that we can carefully delineate criticisms that are sound from those that are not.

The "exploitation theories":

The ideas involved in the view that capitalism victimizes millions of people have been prominent among the invalid objections. A central part of the Left's outlook for two hundred years has been that many millions of people are systematically and oppressively taken advantage of under capitalism, so that the State or an ideological movement needs to take up their cause as a liberating mechanism against the exploiters. (This was the core insight held by the German socialist Ferdinand Lassalle, for example.) If this view is correct, classical liberalism is simply a sham, with "individual liberty" a cover for something insidious (which is precisely the view taken today by the various forms of class, racial and feminist "deconstructionist" theory). The criticism goes to the heart of a "bourgeois free society," seeing it as something far different than it purports to be.

This author analyzed the particular forms of exploitation theory in detail in an article in the Spring 1996 issue of this *Journal*, based on a chapter in his book *Socialist Thought*. Instead of just one theory, there were at least four distinguishable ideas: the socialist version of the Labor Theory of Value; class theory; bargaining power theory as it applies to wages; and bargaining power theory as it applies to other conditions of employment and to many transactions outside the labor market. My opinion was that there is merit only in the last of these (and I will talk about it here when discussing the

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theory of the act of exchange), but that it wasn't a criticism that was fatal to capitalism, since a more sophisticated approach to the legal and ethical framework of the market could remedy it.

Here are summaries of the critiques I made of the three exploitation theories I considered unsound:

> *The Labor Theory of Value*, in its socialist form as propounded by Rodbertus and Marx, says it is unjust for any of the return from an enterprise not to go to the workers; the profit the owner makes from the difference between what the product sells for and what he pays the workers is a type of theft. Thus, the whole "wage relation," which is involved when one person hires another, is a form of oppression. The essential fallacy in this is that it is a moral judgment that presupposes the very thing it is trying to prove. It makes sense if one starts with a socialist liking for a non-market system of production and distribution in which trade and personal benefit play no part; it is absolute nonsense if one accepts private property and the centrality of the act of exchange. Anyone who sees value in the latter will find no merit in a moral judgment condemning profit as theft. Instead of being a reason for socialism, the socialist normative application of the Labor Theory of Value is valid only if someone already accepts socialism on other grounds. The theory commits the fallacy of using the conclusion to justify the premises.
>
> *Socialist class theory* says there is no plurality for workers to deal with; all employers are monolithic as members of the same class, so that going to work for one employer is the same as going to work for any other. If we ask ourselves empirically whether this is really descriptive of things in a competitive market (presupposing, also, that we are talking about a classically liberal society, in which class structure will not have been permitted to harden), it is impossible to say that it is. There is far too much economic and social mobility for that.
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> "*Bargaining power theory*" as applied to wages says that an employer is in a position to dictate wages, telling workers "here it is, take it or leave it." But somebody working for wages will find this only temporarily true. As he talks with others or otherwise

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comes to know the alternative employments that exist, he can respond to better opportunities. Fundamentally, because of mobility, it is supply-and-demand, not employer fiat, that sets wages.

It seems that there can be validity to a "bargaining power" criticism about other matters. This will be discussed here in the critique of the "act of exchange," which will be part of the discussion of *valid* criticisms.

The Berle-and-Means Thesis:

This is the view, commonly attributed to Adolf Berle and Gardiner Means in their 1932 book *The Modern Corporation and Private Property*, that corporate boards of directors aren't meaningfully accountable to the firm's stockholders where the stockholders are many in number and are diffuse and unorganized; most often, stockholders will simply return proxies to existing management, which can reelect itself time after time. Because management isn't effectively accountable to stockholders, it has no "accountability" to anybody. This "irresponsibility" means that corporations should be put under the wing of government.

The first part of this is descriptive, the latter part normative. The description is essentially true, but the normative conclusion doesn't follow for anyone who is not otherwise in favor of government direction of business. Free-market theorists point to the fact that the investing public seems little concerned about this purported "problem," and that in any case the managers of firms are under considerable competitive discipline to do well, because if they do not they will be vulnerable to hostile takeovers. As a matter of fact, a criticism is often made that runs the opposite direction from the Berle-Means Thesis: that management is too concerned about quarterly profits and the serving of stockholders, and should have longer-term goals and even "other 'stakeholders'" in mind.

The attribution of these ideas to Berle and Means has long been an act of ideological fraud – an instance of the long-continuing dissimulation by which American "liberal" thought has obscured its connection with socialist ideas. Attributing it to these two men has made it seem that the idea came from two American "liberals." In fact, by 1932 the point had long been prominent in socialist literature.

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British socialist G. D. H. Cole stated it, and so did Thomas Kirkup in his *History of Socialism* as far back as 1909.[1] Berle himself argued it in *The New Republic* in the 1920s.

Underconsumption-overproduction theory:

According to socialist author Maurice Cornforth, Marxist theory says the trade cycle that periodically disrupts capitalism is due to the employers' keeping workers' pay as low as possible, which causes the workers not to have the means "to consume the products of the ever-increasing industrial machine." Because of this gap, production outstrips purchasing power, precipitating a crisis.[2]

Ironically, this is precisely the problem that is now looming, for the years ahead, from the increasing adoption of non-labor-intensive technology, led by computers and biotechnology. There is going to be a vast "purchasing power problem," as well as revolutionary turmoil and a general refusal to countenance a market economy unless a way is found to include everyone in the productivity of the new technology as it develops through the market system.

Why, then, is the Marxist theory one of the major *erroneous* criticisms of capitalism? Because it has been false during all of the time prior to the present, and even into the future until the displacement of work becomes pronounced. People went from agriculture into industry, and from industry into services, with their standard of living going ever-upward based on increasing real wages and success in the marketplace. The market economy *has* worked well, and the trade cycle *has* indeed, contrary to socialist analysis, had other explanations rooted in monetary fluctuations. The fact that

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[1] See G. D. H. Cole, *Labour in the Commonwealth* (London: Headley Bros. Publishers, Ltd., no date given), p. 107; and Thomas Kirkup, *History of Socialism* (New York: The Macmillan Company, 1909), p. 356. My own discussion of it appears in Dwight D. Murphey, *Liberalism in Contemporary America* (McLean, VA: Council for Social and Economic Studies, 1992), Chapter 10 and particularly pp. 168-174. That chapter was republished in the *Journal of Social, Political, and Economic Studies*, Summer 1992, pp. 183-202.

[2] Maurice Cornforth, *The Open Philosophy and the Open Society* (New York: International Publishers, 1968), pp. 210, 212. This "underconsumption" theory is still relied upon today by so prominent an author as Ravi Batra, an economics professor at Southern Methodist University. See his book *Stock Market Crashes of 1098 and 1999: The Asian Crisis and Your Future* (Richardson, Texas: Liberty Press, 1997), in which he speaks frequently of the "supply-demand gap."

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there will be a distribution problem in the future does not validate two centuries of misplaced carping against an institution that has served humanity so well.

MAJOR PROBLEM AREAS IN FREE-MARKET THINKING

Even though the criticisms just reviewed have not been valid, there is much that properly can be objected to about certain of the pivotal concepts in free-market theory. A strengthening of the theory requires an understanding of these problems.

Insufficiency of the analysis of the "act of exchange":

The "act of exchange" (also called "the transaction") is a key building-block in market theory, something from which all else grows when voluntary exchanges occur by the millions. Voluntary transactions are entered into because all parties are motivated by the prospect, as they see it, of bettering their situations. All parties win. An economic system based on vast networks of such transactions will constitute, in effect, a "positive sum game" from which people in general benefit immensely.

My criticism of the act of exchange won't be intended to diminish our understanding of its vital role in a free society, where voluntary relationships prevail in contrast to a command system. What we will be noting is that the analysis of it hasn't been adequate and that the simple "each person benefits" insight doesn't tell the whole story. A sophisticated analysis is much more complex. Since the ideal of "the transaction" feeds into the "optimum allocation of resources" concept to form an impenetrable closed system that bars other considerations, it is valuable to pierce the over-simplified view of it that allows it to be so easily used in that way.

What about the truism that "all parties benefit?" No doubt in terms of "net effect" they do (at least as the parties see it at the time of the transaction; it is relevant, however, that somebody can easily look back later and say "I was really taken on that one.") But let us consider the situation in which there is "unequal bargaining power." I mean the situation, so common in today's market (and not nearly so common in Adam Smith's day when individuals largely dealt with other individuals), where one of the parties is able to spell out all of the subsidiary terms of the contract on a "take it or leave it" basis.

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Often, the other party doesn't even read the terms, much less bargain over them. Let us suppose you find a farm tractor, a computer, a car, or a dishwasher you like, and decide to buy it. Will you work out with the seller the terms of the warranty? By no means. As a lawyer I can tell you that the warranty will have been written entirely by the seller's legal and marketing departments, often with one eye out for actually limiting, not increasing, the seller's liability and the other for having something that sounds good when it can be said "this carries a warranty."

It is too easy to set up a mental image of "the transaction" as necessarily being an "amply-negotiated" one. In an important transaction between two well-organized parties, every detail of the contract is worked out, negotiated and renegotiated, until each side is satisfied its needs are met in all particulars, at least to the extent that the compromises inherent in negotiation allow. But such full consideration, amply advised by counsel, which is really necessary for a contract to attract our admiration, isn't the model for the typical transaction. And since it isn't, the result in terms of "mutual satisfaction" is often far less than the simple view of "the act of exchange" suggests.

When I graduated from law school, I rented an apartment in Denver. After I moved in, the property manager brought up a lease for me to sign, which hadn't been mentioned before. I read it and was horrified. In among the small print was a provision that the property manager and owner would have no responsibility for harm to me from any negligence of theirs, including from such things as faulty wiring, exploding boilers, and the like. I took the lease to the attorney for the property management company, who told me "we don't change the terms of our lease form for individual tenants; if you don't like it, move" – which is what I did at the first opportunity. Modern landlord-tenant law has since outlawed a disclaimer-of-liability ("exculpatory") clause such as this one on the ground that it is "unconscionable" (so grossly unfair that it violates conscience). But that is a legal development that flies in the face of the simple view of the transaction, which is that it is purely voluntary, everybody benefits, and there's no basis for "paternalism" in "a court's remaking the contract for the parties."

This has vastly important application in the employment relationship. Everybody knows before taking a job what wage is being

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offered, but much of the subordinate features of the relationship will just be put in by the employer and certainly not negotiated with the employee. A person signs on for employment, knowing the wage or salary; but, especially as the months and years go by, the organization sets the "conditions of employment." The employee will choose to stay with the job as long as the net effect is better than any alternative he sees, but there are many things about the relationship that lack mutuality (in the sense of looking after the interests of both parties). Will there be a "fair procedure" for such things as promotion, demotion, transfer, discipline or discharge? Is the employment set up in a way that allows dependable planning for retirement? Is there any way to maintain income in case of disability? What about health insurance? The idea that "both parties benefit" just doesn't look far enough to tell all there is to tell. Most of the time the employment relationship is far from analogous to the amply-negotiated type of contract. These are things that are enormously important to people "where they live" – i.e., in relation to their most basic needs. Classical liberal thought hasn't been sensitive to them, and this has allowed a vast opening for its critics and has also caused the public during the twentieth century, in pursuit of its native commonsense, to see that body of thought as irrelevant to much that counts.

Another weakness in the simple view of the transaction is that it has for the most part been oblivious to the legal, institutional and cultural prerequisites of satisfactory transactions. Most people don't know it, but the wonderful storyteller Jack London was a revolutionary socialist. In his socialist novel *The Iron Heel* a century ago, he made a devastating anti-capitalist point by telling about a man who, though described as a fine worker, lost his arm in an industrial accident because of a momentary lapse of care. Unable to perform the work, he lost his job. There was no insurance, and when the man sued the company to try to recover something, he ran into highly capable corporate attorneys who were able to invoke successfully all of the defenses available under common law negligence theory (the absence of the employer's negligence, the worker's assumption of risk, and contributory negligence).

The point is that the employment relationship was voluntary and an act of exchange in which both parties benefitted – but that it was nevertheless profoundly insufficient to see to the most fundamental

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needs of one of the parties. The world cried out for greater affluence and more sophisticated market development so that insurance could become an auxiliary to the employment relation to cover industrial accident. The "transaction" needed plug-in institutions, something that the theorists of the "act of exchange" rarely see the need to talk about.

This is an important criticism of the theory, which I cite in order to encourage an expansion of the thinking. But it is valuable at the same time to keep these issues in perspective. Otto von Bismarck introduced "workman's compensation" (now called "workers' compensation") into late-nineteenth century Germany as an insurance system which was then copied by other countries. It was part of his social legislation that formed the nucleus for the "welfare state." This would not have been possible, however, if the productivity of the Industrial Revolution and of the marketplace had not already brought about enough affluence so that people could afford it, and if the modern insurance industry had not begun to come into being so that it could serve as an auxiliary institution. Capitalism deserves immense credit in this context. Its theory, though, lagged far behind, having virtually nothing to say about such things as it clung to the over-simplified view of the transaction.

A final criticism of the theory of the transaction is that it doesn't look beyond the parties themselves to account for the entire setting. It sees a broader picture to the extent that it envisions peoples' linking transactions together to form a dynamic economy, but it has no willingness to see detrimental effects that the particular circumstances of trade may bring to a country's well-being. To avoid acknowledging such effects, it prefers to see the act of exchange atomistically as exclusively a matter between the parties. This dropping of context has been especially important in the long-standing "Free Trade vs. Protection" debate. I will talk about this in detail later when we examine the *laissez-faire* view that "free trade [like any act of exchange] is always beneficial."

The insistence that wages are tied to productivity:

It is a truism that if there is no output to be sold, there is nothing from which to pay wages. If productivity goes down, the sum of wages paid out will have to go down, too, unless investors or creditors pump in money to sustain a firm on what would have to be a

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temporary basis, contingent upon things improving.

It is also true under theoretical model-related conditions in a free market that if productivity goes up and yet wages stay the same, profits to the business will rise; that this will attract a flow of other capital, always on the lookout for profit opportunities, into the industry to compete for the profit; and that that will create more demand for the pool of workers, bidding wages up (if the size of the worker-pool remains roughly the same). This is all standard economic theory, which postulates a constant tendency toward re-adjustment within a marketplace in response to opportunities. You will notice that wages do go up in response to the increase in productivity.

The truisms of the preceding two paragraphs are what give rise to the economic maxim that wages are tied to productivity. It is repeated frequently in economic literature. Mark Skousen in *The Freeman* says that "productivity is the key to rising or falling wages. Many years ago, F. A. Harper...wrote a grand little book entitled *Why Wages Rise*...He demonstrated that...'Higher wages come from increased output per hour of work.' Ludwig von Mises adds, 'if you increase capital, you increase the marginal productivity of labor, and the effect will be that real wages will rise.'"[3] Hans Sennholz writes that "working conditions and wage rates depend on labor productivity, which is a direct function of the stock of capital invested per worker."[4] Paul Krugman says in the *Harvard Business Review* that "one last assertion that may bother some readers is that wages automatically rise with productivity. Is this realistic? Yes. Economic history offers no example of a country that experienced long-term productivity growth without a roughly equal rise in real wages."[5]

So here we have it. The theory is presented as "realistic," meaning that it describes the actual situation "on the ground." But you'll notice that the theory contains certain factual predicates, assumptions that must be met for the theory to apply. One of these is that capital will flow to the increased profit opportunity, expanding the amount

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[3] Mark Skousen, "Overworked and Underpaid?," *The Freeman*, 1996, pp. 734-735.

[4] Hans Sennholz, "Notes from FEE," *The Freeman*, November 1996, unpaginated center feature.

[5] Paul Krugman, "Does Third World Growth Hurt First World Prosperity?," *Harvard Business Review*, July-August 1994, p. 116.

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of capital invested per worker and bidding up wages. Another is that the number of people in the pool of potential workers remains approximately the same as it was before (i.e., that the supply of labor wasn't changing as the demand for it increased). Economic theory has to make such assumptions for its analysis. One of its key concepts is *ceteris paribus*, the expressed assumption that "everything else [other than the variable that is being changed] remains the same."

How do these factual predicates fare in today's world? We certainly have the first one – the ready mobility of capital to move toward any profit opportunity. That is one of the more salient features of the global economy, with its worldwide finance (if we ignore, which seems justified in the context of the general point, the many obstructions to total mobility that exist in many countries).

We just as certainly don't have the second one. The more improvements in communications and transportation make labor markets global, not local, the more there will be a vast expansion in the labor pool in both skilled and unskilled areas. The world is "just at the beginning" of this, and so far has barely seen the effects. The day is rapidly approaching, however, when an accountant in Goodland, Kansas, is in direct competition with accountants in New York City, the Philippines and India, because of computers – even if the accountants all stay where they are and don't migrate. Computers and instantaneous communication will place them in "virtual" proximity to each other. To some degree, such labor competition already exists; but it is nothing compared to what it will be. And what happens to the conclusion that "wages will rise" if the labor pool is expanded by a factor of a hundred or a thousand, bringing in billions of people who have hardly been receiving any wage at all compared to what workers in the advanced economies have been getting? The theory will simply say that *ceteris paribus* didn't hold, and that the flow of capital will enhance wages under the new conditions of a vastly increased supply of labor; but that, of course, those enhanced wages will be much lower than they were before for those who had been part of the earlier, much smaller labor pool. In other words, given a worldwide extension of the labor pool and given a sizeable immigration from the Third World, higher productivity will be concomitant with drastically falling wages for many, many workers in such places as the United States and Europe.

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The theory can account for this, but the standard expression that "higher wages are a realistic prediction" certainly does not. It is a case of economists not reexamining the minor premises of their theorems; i.e., not checking how much the facts match what the major premises of the theory call for.

Moreover, we face a new phenomenon. As capital flows in, the theory says, it will create more demand for labor, so that wages will be bid up. Does this take into account that so much of the emerging technology is precisely *non*-labor-intensive, actually *decreasing* by leaps and bounds the demand for labor? Obviously not. Again, it is one of those *ceteris paribus* things. The conclusions don't follow if givens don't stay givens. There is nothing wrong with the theory, which says "here's what will happen if certain conditions are present"; it is the application of it, which blithely assumes the existence of those conditions, that is deficient.

The fallacy of the "optimum allocation of resources" linchpin:

Now we come to perhaps the most important concept, the one that is the linchpin of the entire closed system since it provides the sweeping value judgment that validates the outcomes that arise from the *laissez-faire* market. This is the claim that the millions of acts of exchange that constitute the marketplace make an "optimum allocation of resources." An examination of the writings of prominent market theorists shows that what is meant is not just a technical meaning of "optimum," but a claim that the allocation of resources (and of everything that follows by way of incomes, wages, social position, etc.) in a market economy is the "best" allocation. Unfortunately, this conclusion results from a logical fallacy.

The claim that a market economy automatically makes an optimum allocation of resources is a value judgment that is thought to follow from the idea of "consumer sovereignty" – the point that "consumers are sovereign, since it is their demand that entrepreneurs have to respond to if they are to make a profit." Ludwig von Mises said that "to assign to everybody his proper place in society is the task of the consumers."

To avoid misunderstanding, I should point out that I, too, have favored an allocation of resources and of social position on the basis of consumer choices. I haven't based this conclusion on the ground that that allocation is necessarily best as an allocation. Whether it is

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best or not, I as a classical liberal have supported it because it is the allocation that arises out of freedom. I don't favor individual liberty and the act of voluntary exchange because it produces the best allocation of resources; rather, I favor the allocation of resources because it is the one produced by a free process.

When a market theorist says the sovereignty of the consumers makes the optimum allocation of resources, he is making what is called "a holistic argument." Ludwig von Mises himself is the one who argued most persuasively against "holistic" concepts. Chapter VIII of his monumental treatise *Human Action* contains a section of several pages with the heading "A Critique of the Holistic and Metaphysical View of Society." In the following passage Mises is talking about the imputation of distinct existence to "society" as a collective whole separate from the individuals who make it up:

> The individual lives and acts within society. But society is nothing but the combination of individuals for cooperative effort. It exists nowhere else than in the actions of individual men. It is a delusion to search for it outside the actions of individuals. To speak of a society's autonomous and independent existence, of its life, its soul, and its actions is a metaphor which can easily lead to crass errors.[6]

Such a concept as "society" is useful in many ways, but it contains what we might call "the fallacy of wrongly-imputed consciousness" if it is used in a way that attributes consciousness and decision-making to the abstraction as an aggregate. It is true that a society can make decisions through individuals who are its selected representatives. But the aggregate itself isn't a conscious thing. To talk as though it is is to treat it "holistically," asserting that the sum is different from the particles that make it up. (Interestingly, a human being *is* a validly holistic creature, since a person *does* have consciousness and is in that way more than simply the cells that make him up. But it is a metaphor to speak of society as having its own consciousness.)

The concept of "the consumer" is the same. Consumers taken as an aggregate don't have a consciousness; only consumers as

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[6] Mises, *Human Action*, p. 143.

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individuals do. It is odd that Mises didn't see this, since he saw it so powerfully in other connections.

Now, let us ask: from whence can value judgments come? The answer is: only from a conscious being. Inanimate objects such as rocks, water, clouds and sky don't make value judgments. Nothing is good or bad, desirable or undesirable, to a rock. A God, in most conceptions of God, *is* a consciousness, and so can decide what is good and bad, what is to be preferred and what is not. But note this: between the consciousness of a God and of individual people, there are no consciousnesses. Many thinkers who don't want to base their value judgments on a God feel very uncomfortable about attributing them to no stronger a reed than individual minds and the preferences to which they give rise, and so search for some source of values below God but above individuals. All efforts of this kind demand attributing consciousness to some metaphorical entity that doesn't really possess consciousness. I wrote an article years ago pointing this out about the philosophies of Victor Frankl, Abraham Maslow and Nathaniel Branden, who otherwise are three very distinct thinkers.[7]

Can "consumers," taken holistically, make a value judgment? Are they collectively a consciousness that can decide what is "best"? Of course not. The aggregate does not have a mind in itself, but is the sum of countless individual consumers, each making decisions about what is best in his own case.

Then let us notice that from the perspective of each one of these individuals *as a consumer* the person predictably will not think the allocation of resources flowing *from the total economy* is the best possible. Almost certainly he would prefer an allocation that would bestow more resources on him and the things he cares about. Actually, in spending his own money, he has not given the slightest

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[7] See my "Three Contemporary Psychologists and the Meaning of Life" in *The Occasional Review*, February 1974. It is entirely a postscript to my present discussion to bring it up, but the treatment given to this article provides a hilarious case-in-point about the travails an independent thinker goes through. The editor liked my analysis of Frankl, Maslow and Branden, but when he got to the end and found that I wasn't basing my critique on a belief in God, but rather on the fact that individual people are the source of value judgments, he cut out the final three pages. I had to complain to the journal's publisher, who then insisted that the editor include the conclusion of my article as a "Postscript" in the next issue. So to read the entire essay you have to pick up the ending from the Fall 1974 issue.

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thought to the economy's total allocation; he has only paid attention to his own little corner of the world.

Next, let us think of each individual as *a philosopher or social observer*. Will he then think, as he looks out upon the sum total of what is resulting from market transactions, that what he sees is entirely to his liking in light of his philosophy? Probably no one, including Mises himself, would be completely satisfied from that perspective. There are many things consumed, such as excessive alcohol, dope, pornography, or what-have-you, that hardly square with anyone's idea of what is "best," even from the point of view of those who engage in the consumption (if asked in their sober moments). Indeed, people from competing philosophies and cultures bring very different preferences to bear on what they would like to see happen. It is for them more than just a matter of individual preference or not liking certain features such as drug consumption.

If "consumers" as a metaphor can't judge, and individuals as consumers aren't judging, and individuals as philosophers find aspects to take issue with, and we aren't premising the whole "optimum allocation" claim on a judgment made by God, what is there to the claim that a market economy makes the best possible allocation of resources? Nothing. The most we can justifiably say is, as was said above, that "I will accept the allocation, with a few exceptions as provided by law, since it is what results from a free process." The seeming deficiency in this, and the reason the closed system of market theory has so eagerly accepted the "optimum allocation" argument in its place, is that it has no metaphysical pretensions, and hence much less polemical power.

Socialists, of course, have never accepted that the allocation of resources effected by a market economy is ideal. They consistently urge a different set of priorities. Given that difference, you would think they would have raised the criticism made here, pointing to the conceptual flaw. If any of them has, I am not aware of it. In so competitive a world ideologically, it is amazing that even ones opponents' concepts often go unexamined. Maybe it is because people don't pay all that much attention to what others who differ with them are saying.

Later we will examine Friedrich List's early-nineteenth century criticism of Free Trade theory. It is worth noting that he didn't see the sense of the argument that when people strive to further their

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own interests, they "always further the interests of the community." He cited several counter-examples where it just wasn't true.[8]

The need to qualify property rights theory:

"Private property" is a major element in the classical liberal philosophy, which contains varied theories about its origin and justification. It is a feature that has great utility to a philosophy that wants some sort of individual autonomy and significant limits on the power of the State. A widely diffuse holding of property provides the stuff with which individuals can act, and the diffusion itself means that the State doesn't have a centralized grip on one of the main things that is pivotal to peoples' ability to exist.

Thus, it is sound to be reminded of the importance of private property. Nevertheless, there is one very important question about it:

> *whether the claim to it by the owner is properly i.e. in the context of the philosophy of a free society as best formulated to be considered as absolute or whether on the other hand the ownership shouldn t be seen as often sub ect to a rightful claim for at least part of its value on behalf of the community*

Even to ask such a question is heretical within classical liberal thought. For a century and a half, any admission that private property is subject to qualifications has been thought to create a disastrous loophole through which the Left could attack the entire system of private ownership. During that time, this defensive posture has almost certainly been necessary for precisely that reason (although later here we will see why this may simultaneously have been very damaging to classical liberalism). It has seemed better from a classical liberal point of view to defend the institution entirely, not giving an inch. Henry George and his followers disagreed, but they have remained a minority within free-market thinking.

The problem, as the Georgists point out, is that this total defense hasn't been fully sound. And what is more important now, it will

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[8] Friedrich List, *The National System of Political Economy* (Fairfield, NJ: Augustus M. Kelley, Publishers, 1991 reprinting), p. 166.

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become far less so under the onrushing world conditions. If conservatives, libertarians, and classical liberals are to adapt in a way that will allow their point of view to survive and that will preserve their primary values in a world of vast economic displacement, they are going to have to revise their view of property (including earnings), doing so in a way that is intellectually defensible.

Let us begin with George's insights a century ago, since they voice much of what I have in mind and will get us underway. The first thing to notice is that George was a devout free trader and classical liberal. Most of his writing gave powerful reiteration to the various points of market theory. He was a crusader for Free Trade and against Protectionism (which was the main issue of political economy in the nineteenth century, just as it is becoming again). His intellectual method was that of a moral purist, even though he mixed into this many arguments that were made on purely empirical, utilitarian grounds. Any free market theorist who hasn't already done so will enjoy going back and reading his books. They provide a vigorous defense of the entire complex of ideas that make up classical liberalism as we know it.

They do, that is, with one exception. This has to do with his perception that certain types of property come to their owners unearned, as windfalls merely dropping into some peoples' laps from the fact that they live among other people. Land is the principal form of property of this type. No human being has made the land, although improvements to the land are another matter. The land *per se* comes to have value because of the growth of human population, not because of a creative act by anybody. Since this is so, George saw no reason why land should not be a resource of the whole population, rented out to individuals who want to use and improve it. This rent would then create a fund of money that could be used for a variety of projects that would benefit everybody, as well as for placing a floor under all members of the community to keep them from poverty. In the private property system as it has been known, the owners of property enjoyed an enormous privilege, especially in a predominantly agricultural society such as existed until a few years ago, while those who owned none of it had to toil for everything they got. Such a thing places a serious stain on the property-market philosophy, since it isn't fundamentally just.

George quoted Herbert Spencer, whose credentials as an

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individualist philosopher are solid, as agreeing with him; and he said he was merely picking up from the French thinkers Quesnay and Turgot, whose ideas fed into Adam Smith's. Rather than include a number of direct quotes from George here, I am including them in the endnote.[9]

It is significant that he thought the same applied to minerals: "...the ground values of great cities *and mineral deposits* are due to the

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[9] Here are passages from Henry George's *Protection or Free Trade* that illustrate the summary I have made in the text:

P. 273: "Land is not the produce of labor; it existed before man was...[T]he value of land is a value of appropriation, based upon the amount that can be appropriated, and therefore tends to increase as the progress of society increases production."

P. 272: "If infants ceased to be born and men to grow up in America, his land would be valueless. The profits on such investment do not arise from the growth of land or increase of its capabilities, but from the growth of population."

P. 280-1: "All we have to do is to treat the land as the joint property of the whole people...In other words, we can leave land now being used in the secure possession of those using it, and leave land now unused to be taken possession of by those who wish to make use of it, on condition that those who thus hold land shall pay to the community a fair rent for the exclusive privilege they enjoy--that is to say, a rent based on the value of the privilege the individual receives from the community in being accorded the exclusive use of this much of the common property, and which should have no reference to any improvement he had made in or on it, or to any profit due to the use of his labor or capital."

P. 281: "As Herbert Spencer has said of it: 'The change required would be simply a change of landlords. Separate ownership would merge into the joint-stock ownership of the public.'"

P. 284: "A large and constantly increasing fund would be provided for common uses, without any tax on the earnings of labor or on the returns of capital."

P. 311-2: "Among the purposes which will suggest themselves to the reader by which the surplus income of the community could be used to increase the sum of human knowledge, the diffusion of elevating tastes, and the gratification of healthy desires, there is none more worthy than that of making honorable provision for those deprived of their natural protectors, or through no fault of their own incapacitated for the struggle of life... Citizenship in a civilized community ought of itself to be insurance against such a fate." One possibility: "No taxes at all, and a pension to everybody" [quoting an English member of parliament].

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general growth of the population" [emphasis added].[10] Natural resources are not created by anyone's effort. They take on value by virtue of the presence of people who will find them useful, and the value increases as population grows and as an industrial system and way of life come to be centered upon them. George would have the community charge a rent equivalent to this value. In addition, of course, a major portion of resources' value is attributable to other things traceable to specific effort -- i.e., the invention that discovers their usefulness, and the capital and labor that go into extracting and applying them. These, pursuant to George's logic, would not be charged a rent, since they are not a windfall but the product of someone's thought or effort.

These were the insights held by George and several other major classical liberals. It may be an eye-opener to some that it has not exclusively been socialists who have believed that these types of property should belong to the community as a whole. George felt that the system of private property would actually be stronger, and certainly much more morally justified (and hence defensible), if it did not include a privileged position for some.

As mentioned earlier, most classical liberals have resisted this, preferring an across-the-board system of private property, without any exceptions that could be expanded to destroy the system as a whole. That resistance, though I have thought it was best, has had its costs, probably the major one of which is that the market has been left to seem "heartless" to those who haven't fared well in it. Labor has had a certain affinity to capitalism because workers in general aspire to be among the middle class, but the chance for a bond of alliance and sympathy between those who have done the drudgery and others has been surrendered. By not following George, classical liberalism set itself up to allow socialism to "occupy the moral high ground" throughout the twentieth century. As I ponder this, I am by no means certain it has been wise to follow the majority classical liberal position.

Whatever was wisest in the past, it is rapidly becoming clear that classical liberalism must immediately move to George's position – and indeed to an expanded view of it. When work is displaced and either

[10] George, *Protection or Free Trade*, p. 322.

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vast unemployment or marginalized work results, people are going to be crying for a place at the table; and they will have been knocked away not because of any flaw in their character or lack of effort on their part, but because of omnipresent forces over which they have no control. Their need is, however, only half of it: the second half is that under the new technology there will be some people reaping immense wealth, only a certain fraction of which they will have created through their own contributions. This is the stuff of which revolutions are made. Notice, too, that it would be a rotten version of classical liberalism that would defend it. This would be a version that by clinging to the closed system under radically changed circumstances will have forfeited its tie to the main classical liberal values. If the "act of exchange" and the resulting allocation of resources remain classical liberalism's central criteria under the new circumstances, it will be totally inappropriate. The act of exchange ought to remain central to the productive economy, but the distribution of the product needs to be qualified by the insight into what has been earned and what has not.

Why is it true that those who reap immense compensation from the new technology will not have earned all of that return? (In the closed system, they will be said to have, on the simple ground that it is coming to them through contract, reflecting acts of exchange. But it is that way of looking at it that has to be seriously qualified.) The answer is: because each person makes, at best, only a relatively small, incremental addition to a technology that has been built up, like a coral reef, through the efforts and intellectual contributions of countless predecessors. Imagine a young person in the year 2030 who works as a technical specialist in some advanced technology, being so good at it that the rewards are extremely high. Everything he does will be standing on the shoulders of people developing computers, biotechnology, robotics, genetics, etc., today, before he is even born. What he brings to it will be valuable, no doubt, but it will be creating only part of the value. Humanity itself will have created by far the largest part. To some considerable extent, this has always been true. It could be overlooked for the sake of individual autonomy so long as "the system worked" to provide opportunity for everybody. It must not be overlooked at such time as the system comes no longer to function acceptably in that sense.

This author is one who has always worked for such attainments as

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have come his way. I have seen others who haven't applied themselves so diligently who haven't done as well. So I have a strong moral conviction that what people get, they earn. This change in perspective, acknowledging that a significant part of someone's success is derived from what other people have done or from the whole context of developed community, isn't one that I would naturally find congenial. But isn't it true? And isn't it essential? Especially as the displacement creeps in upon us?

The implications of this insight are extensive. It means that there will be no moral crime, no violation of private property or of contractually-earned income, if a community treats a significant amount of the economic product of the new technology as a common resource to be used or distributed for the good of all. It means, too, that there can be, as George wanted, a full return to people for their own labor, intelligence, or capital. If we wish to maintain a thriving competitive market economy, the reward to those contributions will be necessary and rightful. That reward simply won't be the entire return, but something more commensurate to the person's own input. In *A Restatement of Economic Liberalism* (1988), Samuel Brittan, who centers his thinking on Friedrich Hayek's, has already thought along these lines, although without seeing the coming displacement of labor as the reason for its necessity.[11]

There is no way the exact proportion between what humanity has contributed and the individual has contributed will be determinable. This fact shouldn't be too great an objection; the division can be made in keeping with the criteria of the "rule of law" – i.e., according to established rules known in advance and applicable to everybody. Recent data shows that in 1980 executive compensation was between 30 to 40 times that of the firms' average workers, whereas by 1990 this had grown to a difference of 130-140 to 1. Let us say that tax law in the United States were to provide that the highest management person in a firm should be entitled to thirty or even fifty times the average earnings (or some multiple of the earnings of the lowest-paid employee), but no more; and that the rest should be taxed away. Would that be unjust? Would it be something that "no

[11] Samuel Brittan, *A Restatement of Economic Liberalism* (Atlantic Highlands, NJ: Humanities Press International, Inc., 1988), p. 300.

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market economy can live with?" Hardly. Enormous incentive would still be there for executive leadership. Whether that leadership would abandon the United States for some other place where a higher ratio is permitted would depend on a number of factors, not the least of which might be an international tax convention setting the same ratio for all countries or at least for all advanced economies.

The same can be said for everyone who makes a vast fortune in today's (and especially tomorrow's) mass market. If a professional football player, or a movie actress, or a rock star, makes $20 million dollars in a year, how much of that is due to the person's own ability and contribution, and how much of it is because technology has evolved to the point at which communication makes available a worldwide audience? Did the ballplayer, actress or rock star create that system of worldwide communication, with its fiber optics and satellites? No. We are tempted to say, only half tongue-in-cheek, that Bill Gates did; but even that would be an immense simplification, because Gates is himself standing on the shoulders of countless ingenious people like himself.

If we may add still another shocking heresy (and a heresy to no one more than to myself), it is to say that this fully justifies a system of strongly progressive taxation. Once the non-labor-intensive technology has more fully come in, if some people become enormously wealthy and others have no or only very meager earnings, there should be no objection from a classical liberal point of view to taxing away a good portion of the high earnings to make provision for everyone in the society. To the objection that "that would run afoul of, maybe even totally destroy, the sanctity of earned income and private property," it must be answered that it does no such thing – and that there is no alternative. A market economy going forward to new innovative heights, with free individuals employed within it through contract, all within a setting in which everyone in the society shares in the prosperity and has purchasing power with which to buy the products – all this is much more compatible with classical liberal aspirations than for the market and individual liberty to drown in a sea of opprobrium and revolution.

Many market theorists will doubt whether the displacement and polarization will actually come about. They may be strongly inclined to think I am overstating what is going to happen. (They will want to be alert to, and to avoid, a psychological possibility that may

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explain, as time goes on, their expectation of continued normalcy: a willingness to accept a growing impoverishment for the less intelligent half, or some other fraction, of mankind as being a "natural condition." Such an insensitivity is altogether possible, since it has been thought normal and appropriate in countless societies already. I shouldn't think that any true classical liberal would build his feeling of normalcy on a lack of empathy. There is reason to fear, though, that some of those who are entranced by the closed system of market thinking may easily talk themselves into doing precisely that, since they are in a mental box that is hard to escape. It is a part of all classical liberal thinking, of course, to accept the inequalities that flow from the normal working of the market. Their ideology may keep them from seeing the distinction between this and the roots of inequality in a world beset by economic displacement.)

Let us assume, moreover, for sake of argument, that the new technology does not radically alter the shape of things, that most people stay employed without seeming to become severely marginalized. What then? Will not much of what I have just said, building upon Henry George, still be true? Doesn't it provide a rationale for making the market society "more just"? Do we have to be socialists to think so? The questions pretty much answer themselves.

The scope of this article does not permit a discussion of the ways to shift to a "shared market economy" in which much of the stock in business is owned by the entire spectrum of people in the society, while a competitive world market continues to go forward with the participants in it making a fortune (albeit limited as I have just indicated). There are ways that this can be done that will least disturb the current system of income and property. Progressive taxation to accomplish that spread of ownership will be justifiable, but may not be all that necessary.

Before we conclude, a question remains about how the "unearned value" of something like land or minerals can be taxed away in today's society without in effect expropriating the present owners. Those owners have paid for the property when they have acquired it, so the unearned value has gone to the sellers (and actually to their predecessors in a long chain of title). In applying George's point, it would be enough just to tax the unearned increment that arises in the future. Assume, for example, that someone buys land for $100,000

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and it increases in value to $200,000 as the city grows up around it, and that none of that increase is due to improvements made on the land. This increase, as adjusted for the inflation that will have occurred during the period the increase in value has occurred, could (and should) be considered as accruing to the community as a whole. It wouldn't be just or feasible to take for public purposes the portion of the value of the land represented by the purchase price.

The insistence that international Free Trade is always beneficial:

One of the more beneficial features of a market economy, according to economic theory, is that the act of exchange and search for profit lead to an elaborate division of labor. The continuing tendency is toward everyone's doing what he can do at lowest cost, while others gravitate toward what they can do most cheaply. If firms in one country are able to make shirts most efficiently, and farmers in another country are best at growing papayas, both will do the thing for which they are best suited. And, as David Ricardo argued with his "law of comparative cost," this will occur even if one set of producers is better *at everything* than the others; it will profit the former more to leave the things they do less efficiently to the latter, even though they are better even at them than the latter. Everybody will have something to do, and by the division of labor efficiency will result compared to a situation in which everyone tries to be a "Jack of all trades" and do everything.

Adam Smith expressed this in a famous passage:

> It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them from the shoemaker. The shoemaker does not attempt to make his own cloaths, but employs a taylor. The farmer attempts to make neither the one nor the other, but employs those different artificers...
>
> What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our industry, employed in a way in which we have some

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advantage.[12]

When the efficiencies of the division of labor are added to the notion of the "optimum allocation of resources," an abiding conviction seems justified that any governmental intervention into the process detracts from human well-being rather than adding to it. This amounts to a powerful argument for *laissez-faire*. When applied in the international arena, it is a compelling argument for Free Trade. Any attempt by governments to impede the flow of goods and services will be retrogressive. Likewise, any effort to develop trades or crafts within a given nation that is not in line with "buying most cheaply" seems transparently wasteful.

This view sees important parts of the truth. The division of labor *is* highly beneficial, just as described. But, as with much else in the *laissez-faire* ideology, it is not the *whole* truth. There are at least three reasons we shouldn't accept the view as part of a closed system that allows of no (or only minor) departures:

• *That Free Trade looks at the process as a whole, but overlooks the aspirations of various of the parts, which if developed might eventually benefit the whole more than if they are not developed.* According to Adam Smith's principle, it is best to acquire something from the cheapest source, and that will often be from someone other than yourself. Today, if the Taiwanese produce VCRs most cheaply, by all means buy from them; ones own industry can do something more profitable even if this means losing all knowledge or other capacity needed for making VCRs.

I have been amazed to find that the early nineteenth-century German economist Friedrich List, who is almost always put down dismissively in market theory as the principal apologist for "Protectionism," actually had a much more sophisticated understanding of international trade than did Smith or Ricardo. List was no apologist for statism, but was actually quite a thoughtful classical liberal. Before we proceed, it will be worthwhile to become more acquainted with his thinking. As we did with Henry George's views, we will provide a summary in the text and leave extensive

[12] Quoted by Irwin M. Stelzer in *National Review*, March 16, 1992.

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quotation to the endnotes.

List's classical liberalism shone through all his work, except that it was a liberalism that saw the individual, and trade itself, as part of a free community. Far from being a statist, he said that protection (such as tariffs) is only good if it is in combination with progressive civilization and free institutions. By no means did he fully reject the Free Trade idea, although he concerned himself with how each nation fared in the course of it. He was strongly favorable to individual liberty, but again qualified one value by keeping others in mind: individual liberty flowers as part of a well-ordered free society. List strongly opposed socialism, such as was then presented in the writings of Saint-Simon and Fourier, as the annihilation of individual liberty.[13]

A certain J. S. Nicholson wrote the introduction to the 1904 edition of List's work. Nicholson sums up one of List's central observations about trade: "To buy at the time in the cheapest market and to sell in the dearest may not always be the wisest national policy. The distinction between present and future advantage from the national standpoint is fundamental throughout the whole work."[14] A key problem with Smith and Ricardo is that they looked only to what is advantageous *at present*, which is a remarkably over-

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[13] Friedrich List, *The National System of Political Economy* (Fairfield, NJ: Augustus M. Kelley, Publishers, reprinted in 1991). See the following passages:

> P. 112: "A restrictive commercial policy can be operative for good only so far as it is supported by the progressive civilisation and free institutions of a nation...."
>
> P. 175: "A nation in its normal state...must afford to those who belong to it a high degree of security and liberty, and must promote religion, morality, and prosperity; in a word, must have the well-being of its citizens as [its] object."
>
> P. 335: "A high degree of economical development has only been attained in those nations whose form of government has been such as to secure to them a high degree of freedom and power, of steadiness of laws and of policy, and efficient institutions."
>
> P. 360: "The Saint-Simonians and Fourrierists (sic) ...Their annihilation of individual freedom and independence is their weak side; with them the individual is entirely absorbed in the community...."

[14] J. S. Nicholson in his introduction to List, *The National System*, no pagination for the Introduction.

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simplified perspective. People who read them naturally assume that an infinite series of moments in which a person achieves present advantage must add up to long-term advantage. But that isn't necessarily so.

Let us go back to Adam Smith's example of the tailor and the shoemaker. The tailor, he says, should not himself make shoes, but buy them from the shoemaker, who can make them for less than he can. But what if the tailor thinks he could become a better shoemaker than the shoemaker now is, which if true means they should trade places? To accomplish this development of his newly-aspired-to skill, he has to set out to make some shoes, even if at first they aren't as cheap as he could buy from the present shoemaker. Applying this to an entire country, the given situation of "who's best at something" will remain static, as though it were set in cement, unless some people break out of the mold to develop new skills at which they previously haven't been the most capable.

This is the basis for the "infant industry" exception to the Free Trade principle. It should, however, be understood as going far beyond its traditional meaning. Those who are second-best had better continue and work on their capability rather than drop out of a market altogether if they hope ever to become the best. To turn markets permanently over to those who are now the best is to insulate them from competition and to atrophy the abilities of the others. The retention and development of capability will also depend upon the societal and cultural context in which the attempt is made, and is not entirely a matter of individual effort. The many conditions bearing on "who can produce something most cheaply" can change over time, making one source the cheapest now, another the cheapest later. This is especially true in today's world of hyperspeed-changing technology and world markets. Many competitors need to stay well-prepared right on the fringe, rather than to surrender their skills and their productive plant. They even have the potential of contributing to technological innovation as they strive to leap over the existing leaders. Seen in light of these things, the "infant industry" phenomenon takes on a permanent and widespread significance over time, and is not just a "one shot" development of a nation's industry.

There has been a growing recognition in economic theory that this

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is so.[15] Stephen S. Cohen and John Zysman ask "why can't the United States simply buy semiconductors and embed cheap semiconductors into expensive computers?," but then answer it with another question: "Will U.S. producers of computers be able to stay ahead of Hitachi if they depend on Hitachi for semiconductors? ... If the technology is changing rapidly, the question becomes vital ... Dependence on foreign sources for a technological innovation could affect the entire range of user industries...."[16] List's insights about these things are set out in the endnote.[17]

The *dynamic* view of comparative advantage – that competitive standing changes over time if some of those who are not the cheapest producer retain their capacity to compete – is a much more sophisticated view of the market than the *static* view. That the thinking should have stayed at that unsophisticated level is typical of the closed-system market rationale. The static concept actually works

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[15] See Michael E. Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), pp. 12 and 13: "The standard theory assumes that there are no economies of scale, that technologies everywhere are identical, that products are undifferentiated, and that the pool of national factors is fixed. The theory also assumes that factors, such as skilled labor and capital, do not move among nations. All these assumptions bear little relation, in most industries, to actual competition... More and more industries do not resemble those that the theory of comparative advantage was built on."

[16] Stephen S. Cohen and John Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy* (New York: Basic Books, Inc., Publishers, 1987), pp. 238-9.

[17] List, *The National System*:

> P. 80: "How pitiable and unpractical seems that theory of political economy which would have us refer the material welfare of nations solely to the production of individuals, wholly losing sight of the fact that the producing power of all individuals is to a great extent determined by the social and political circumstances of the nation."
>
> P. 138: "It is (says J. B. Say) that science which teaches how riches, or exchangeable values, are produced, distributed, and consumed. This is undoubtedly not the science which teaches how the *productive powers* are awakened and developed, and how they become repressed and destroyed" [List's emphasis].
>
> P. 295: "As in all human institutions so also in industry, a law of nature lies at the root of important achievements which has much in common with the natural law of the division of labor...[this is] the confederation of the productive forces, whose principle, namely, consists in the circumstance that several generations following one another have equally united their forces towards the attainment of one and the same object...."

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in favor of less innovation, less competition, less ultimate consumer satisfaction. And it arrives at that because it looks no further than to a simplistic "truism": that "what is beneficial to the parties in one transaction, or even a string of transactions, must be best for long-term benefit."

This realization is not just important for economics and efficient productivity. It leads on to an understanding that given peoples and nations are *not* necessarily well-advised to settle for being an increasingly remote second-best in things that they consider important to themselves. This is important to culture and nationality (things that are played down in classical theory in part because they are thought to run counter to a developed division of labor). If the iron logic of static comparative advantage loses its grip, people will find themselves able to think in terms of their own preferences about their development as a people or a nation. Cultural preferences *can* come in without being tagged as economically harmful.

List was primarily concerned with how his own people, the Germans, could amount to anything as a productive, talented people if "buying cheapest" from the British, who already had a magnificently developed industrial and commercial economy, was, at every point along the way, the sole criterion.

Many nineteenth-century Americans felt the same concern. Again, if "buying cheapest" from Britain controlled, the United States would remain an agricultural country and wouldn't develop its own industrial, commercial capacities. The "comparative advantage" of the time would be taken as a given. Because so many Americans realized this, average U.S. tariffs were set at over 30 percent during the period between 1865 and 1900; James Fallows explains how national circumstance molded the national outlook: "While American industry was developing, the country had no time for *laissez-faire*. After it had grown strong, the United States began preaching *laissez-faire* to the rest of the world."[18] Economist Ravi Batra of Southern Methodist University says that during the nineteenth century the United States "became the preeminent economic power in the world. Would free trade have done that? Absolutely not. If it were up to free traders,

[18] Patrick Low, *Trading Free: The GATT and US Trade Policy* (New York: The Twentieth Century Fund Press, 1993), p. 53; James Fallows, "How the World Works," *The Atlantic Monthly*, December 1993, p. 80.

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America would still be a prominent agrarian economy." He adds: "The U.S. success occurred because the nation was able to generate the ingredients for growth – large consumer markets and vigorous competition – even in the absence of foreign trade." A key to this was fierce domestic competition.[19]

• *That in the new age of unemployment or of marginalized work, it will be essential that the closed system be departed from enough to allow a solution to the dual problems of distribution and purchasing power.*

I haven't been eager to become involved in the Free Trade vs. Protection argument, which has raged for hundreds of years. I raise it now because it was an eye-opening experience, in terms of my own classical liberalism, for me to read List; and because his insights add so much to an intelligent critique of the closed system of market thought. That critique is imperative now that world changes are bearing down on us in ways that will make a lock-step adherence to that system disastrous.

The idea of a "shared market economy" – in which all members of a society receive shares in index mutual funds that represent market-wide investment in the competitive economy - will scandalize the closed-system ideology. To it, such a thing will be "government intervention" and "giving people something for nothing." Moreover, the effort by individual nations to deal with this need, necessarily through political action to create the broad sharing of ownership, will seem "impermissible economic nationalism," especially since no one people can conceivably share ownership with everyone in the world and will have to limit the sharing to its own members. Accordingly, stringent ideological barriers stand in the way of solving the coming "crisis of the [relatively workerless] market." Those barriers have to be removed if the solution is to be accomplished. And the best way to remove them is to see that they really don't make sense anyway – certainly not to a conclusive extent.

• *That in the coming age of reduced scarcity, in which technology is so incredibly productive, the fine-honing of degrees of economic*

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[19] Ravi Batra, *The Myth of Free Trade* (New York: Touchstone Books, 1993), p. 137.

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efficiency won't be nearly so important, anyway, as it has been in the past or as economic theory has described it. This makes it increasingly justifiable for local peoples to develop preferences as to the direction of their own activity.

Cultural conservatives of all persuasions, Left or Right, have thought all along that market ideology puts too much stress on economic performance and not enough on "the small platoons to which people belong" - family, community, a person's own country. It is not just the ideology that leads to this deracination: the mobility that a market economy demands is a force that breaks these local bonds, such as when adult children, say, move half-a-continent away to pursue jobs.

The incoming technology can, if people choose, shift the balance in the other direction. Comparative productivity may become far less important, relative to other values, in a world in which there is abundant productivity. We can think of this in economic terms as a matter of "marginal utility": the utility of additional increments of productivity becomes far less when the increments are on top of an already-vast productivity; and the relative utility of other things becomes higher. However, to give expression to this heightened interest in non-economic values, people will have to depart from the market view that productivity trumps everything else.

Conclusion

Departures from *laissez-faire* ideology do not demand that a competitive global market be abandoned. They simply mean that other needs can be satisfied, especially as those needs become vitally important. Nor does a broad-based sharing of the ownership in the economy mean that those who are active in the economy cannot make additional money or hold additional ownership. Indeed, shared ownership only has value if the economy itself remains innovative and highly productive. A consensus has properly come into being in recent years that this requires a competitive market system.

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Tibet: Endurance of the National Idea

Stephen R. Bowers
and
Eva M. Neterowicz

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From Communal and Communist Bonds to Fragile Statehood: The Drama of Ex-post-Yugoslavia

Tomislav Sunic
Croatian Embassy, Brussels

The author surveys the socio-political forces behind the recent conflict between Serbs, Croats and Moslem Bosnians in the former Yugoslavia and concludes that the centuries-old ethnic tensions were actually ascerbated by state-enforced multi-culturalism under the Titoist regime and are today further ascerbated by the ongoing Marxist mind-set which survives as a legacy from Communism among many political actors in the no independent ex-Yugoslavian territories.

Key Words: Yugoslavia, Serbia, Croatia, Bosnia, Tito, state-enforced multi-culturalism.

In 1991, a set of different, often mutually excluding, circumstances led to the dissolution of Yugoslavia and to the subsequent war between its main ethnic groups, notably the Serbs, Croats, and Bosnian Muslims. During the "Greater Serbia"-inspired Yugoslav aggression on Croatia, and later, during the interethnic war in Bosnia-Hercegovina and following the signing of the US-sponsored Dayton peace agreement in December 1995, a multitude of analyses were provided as to the causes of the conflict. Crimes committed by the belligerents were also reported worldwide. Possible military and legal scenarios for the region, and particularly for the much smaller multiethnic state of Bosnia-Hercegovina, are still being debated.

While much has been written about the major culprits in the conflict and their roles in the ex-Yugoslav drama, relatively little has been said about the diverse ethnic groups' perceptions of each other, or about their sense of nationhood and statehood.[1] Furthermore, little has been said regarding the role of the Titoist ideological heritage and the communist mindset which was a significant factor

[1] See, Joseph Krulic, "Les Croates, les 'Musulmans' bosniaques, les Serbes et la question de l'Etat-nation," in *Nations et nationalismes* (Paris: éd. La Découverte, 1995), pp. 108-113.

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contributing to the conflict – and which still subsists among large segments of the new post-communist citizenry. In the aftermath of the war, the new political elites which emerged on the ruins of the old communist Yugoslave elites like to use Western terms and slogans, such as "free market," "parliamentary democracy," and the like, although beneath their rhetorical veneer little substantive change has occurred. The old communist, clientelistic, and clannish structures still persist.

On a somewhat different level of analysis, the dissolution of multiethnic communist Yugoslavia in 1991 is also raising an array of disturbing questions regarding the viability of multiculturalism in Western Europe, and its chief engine, the European Union. To what extent was the multiethnic conviviality between the two pivotal ethnic groups in the former Yugoslavia, notably the Serbs and Croats, real or feigned? Was the pluri-ethnic European Union at the time of the recent war in neighboring territories of the former Yugoslavia itself so "balkanized" that its political elites could not find a consensual and timely response which might have prevented the war from taking such a devastating turn? The war in ex-Yugoslavia can be studied from a multitude of academic disciplines; e.g. anthropology, sociology, psychology, and international law, with each, seemingly, providing interesting, albeit different conclusions. Arguably, the bygone war in the former Yugoslavia, with its cortege of interethnic and intercommunal violence unseen in Europe since 1945, may also cast a rather gloomy light on the possible state of affairs in a future European Union faced with interethnic confrontation in some multiethnic member state. While none can imagine, even in their wildest dreams, a war between Denmark and Germany over Schleswig-Holstein, or a war between Germany and France over Alsace, the possibility of inter-communal violence between ethnic Turkish gangs against German gangs in Germany, with the spill-over effects on the international community, is no longer a totally science fiction scenario.[2]

Already one conclusion can be offered about the past war in ex-Yugoslavia: similar conflicts, albeit in a different form, can occur

[2] "Zeitbomben in den Vorstadten," *Der Spiegel*, April 14, 1997.

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again, be it on the inter-ethnic smaller level, or on the intra-ethnic larger level.

What strikes one most, however, in the analysis of the past war in ex-Yugoslavia is that there is seldom any mention of the old communist and Titoist state structure as one of the main causes of the conflict. One cannot dismiss the idea that the war between Serbs, Croats, and Bosnian Muslims was a by-product of false state-enforced multiculturalism under the rule of Josip Broz Tito, mixed, in some regions, with the traditional Balkan spirit of clannishness and clientelism that was only strengthened during the period of communist domination. A second tentative hypothesis could be offered, namely that the war in the ex-Yugoslav republic of Bosnia-Hercegovina was also waged, if not directly between its former communist elites, then indirectly, and to a large extent, by their communized subjects, with all their intricate communal ties, so typical for the whole Balkan area.

The Balkan peninsula has traditionally been characterized not so much by the sense of solid ethnocentrism of its diverse ethnic groups, as by the divergent forms of communal bonds within each particular ethnic group, often at odds with the other local community *within* the same ethnic group. The sense of statehood, taken as something normal in Western Europe, has traditionally been unknown in the Balkans. If one excludes the central-European and Western-oriented Slovenes and Croats, the remaining ethnic groups of the ex-Yugoslavia, and particularly those living in multiethnic Bosnia-Hercegovina, have dwelt for centuries in family-oriented neighborhood (*komsiluk*)-like structures, where the sense of small village identity and religious affiliation preceded that of both the individual and that a state-oriented ethnic group.[3]

Furthermore, it should not come as a surprise that for the two main ethnic groups, i.e., Western-oriented Croats vs. Eastern-oriented Serbs, the religions of Catholicism and Christian Orthodoxy, respectively, have not just been a simple matter of theological belief, but also political and cultural repositories, which, according to their separate views, distinguishes them from each other – regardless of

[3] Michael W. Weithmann, *Balkan-Chronik. 2000 Jahre zwischen Orient und Okzident* (Regensburg/Graz: Verlag F. Pustet, 1995).

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how much Serbs and Croats may present to an outside observer striking anthropological and linguistic similarities. Croats have historically defined themselves as part of Western culture and civilization; in contrast to Serbs, who have historically seen themselves as the best custodians of southeastern pan-Slavism and its latest offshoot, the state of Yugoslavia. For central-European Croats, particularly those living in more or less homogeneous Croatia, the past war was interpreted as a Serb aggression. But how to explain the conflict in neighboring multiethnic Bosnia-Hercegovina, if intra-communal feuds and cleavages within Bosnia's Serb, Muslim, or Croat communities, respectively, were rather common features during the conflict? The spirit of local adherence, i.e. "local patriotism," in some instances even surpassed ethnic affiliation of each ethnic group. During the past war this often led to strange supra-ethnic alliances, notably when rural Serbs in the occupied Croatian region of Krajina sided with rural rebel Muslims from the north-western Bihac pocket of neighboring Bosnia who defied the central urban Muslim-dominated government in Sarajevo. During the Croat-Muslim conflict in southern Bosnia-Hercegovina in 1994, some Croat enclaves in northern Bosnia actively participated, along with regular Bosnian Muslim military units, in defense of the country against Serb aggression. Meanwhile, Serb rebels, along with units of the remnants of the Yugoslav Army, often "rented" their services to Bosnian Muslims, who were besieged by Croat militias in southern enclaves of Bosnia-Hercegovina, notably the town of Mostar.[4]

Most of the blame for the past conflict should be put on the former communist state structure and its architect, the late Josip Broz Tito. The former communist elites, in the now defunct communist federal republics, never genuinely tried to establish an interethnic and democratic dialogue among former Yugoslav citizens. The lack of mutual interethnic understanding considerably paved the way for the subsequent conflict. Just as the past war was unique in its character and may often be hard to understand to an outside observer, so was the former Titoist Yugoslavia presenting features of feigned multicultural conviviality, which defied all academic models and

[4] Xavier Bougarel, *Bosnie, Anatomie d'un conflit* (Paris: ed La Decouverte, 1996), p. 63.

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paradigms.

In studying the dissolution of communist Yugoslavia, it is worth recalling that in 1945 communism in Eastern Europe was imposed by Soviet tanks. Only in Tito's Yugoslavia was communism a homegrown, "sui generis" phenomenon. After its break with Stalin in 1948, and until its own break-up in 1990, Tito's Yugoslavia was, so to speak, the most liberal country in the communist Eastern bloc. Tito managed to keep the country together by taking advantage of undercurrent inter-ethnic and intra-ethnic strains between and among different ethnic groups, and by punishing dissidents, turn by turn, from each of the six constituent Yugoslav republics. It is questionable, indeed, whether the Yugoslav experiment within such a quasi-"liberal" framework would have lasted long had it not been for Tito's successful positioning of one ethnic group against the other.[5] Tito enjoyed considerable popularity, not only among the constituent Yugoslav peoples, but also among some Western rulers who had their own vested geopolitical interests in the region and who by no means wanted Yugoslavia to disappear from the map. Tito was a shrewd Balkan leader; under the veneer of "liberal socialism," he deliberately kept Yugoslavia's borders open in order to defuse any potential dissent and any looming secessionist threat.

Even after his departure, little mention was made of the communist repression which continued unabated. In the last years of Yugoslavia's life, notably in 1985, the country had an elaborate network of secret police ("UDBA")-controlled Yugoslav journalists and Yugoslav diplomats infiltrating emigre groups, particularly the Croatian Diaspora around the world.[6] In 1985, during the process of liberalization in the Soviet Union and Eastern Europe, Yugoslavia had over 800 political prisoners, most of whom were Albanians from Kosovo and Croats from Bosnia-Hercegovina. Yet the fame of the Yugoslav open borders policy, coupled with easy credits coming from the West, as well as seven million Yugoslav citizens holding passports, gave the image that Yugoslavia was indeed the most liberal communist country, with a glorious future.

In order to debunk the past multicultural Yugoslav fiction, which

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[5] See my *Titoism and Dissidence; Studies in the History and Dissolution of Communist Yugoslavia* (Frankfurt: Peter Lang, 1995).

[6] "Ein Spinnetz totaler Uberwachung," *Der Spiegel*, March 12, 1984.

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led later to a very violent dissolution of the country, one must look at the profile of the Titoist state and the mindset of its citizens. This may probably help us understand today's lack of civic responsibility and state-identity that can be felt among large segments of citizens of the newly emerged countries in the region, and particularly in Bosnia-Hercegovina. The much vaunted solution of the national question in ex-Yugoslavia was basically a self-serving manifesto of the Yugoslav Communist Party – in which nobody seriously believed. Naturally Yugoslavia could survive only as a one party police state – not as a democracy. Paradoxically, the democratization of Yugoslavia, which began in 1990, led to its violent dissolution. Needless to say, during Tito's experiment, some foreign starry-eyed students of the Yugoslav experiment tended to be more pro-Titoist, than Titoists themselves. Often it was not recpgnized that Tito's Yugoslavia could exist only by sheer iron rule of its communist leaders.

Tito never made an attempt to promote a free dialogue between Serb and Croat intellectuals. This, in hindsight, is understandable, given that the entire Yugoslav experiment was based on a dubious monolithic historiography. Both Serbs and Croats had valid reasons to harbor strong resentments against each other, suspecting each other of Titoist favoritism. The official communist historiography imposed on Yugoslav citizens by Titoists and his court historiographers poorly squared with unofficial nationalist narratives of Croats and Serbs, in which each ethnic group saw itself as the victim of the other, and where each suspected the other of being a hidden "fascist-ustahi" or "fascist-chetnick," respectively. Croats dwelled in their national myths; Serbs, by contrast, frequently exaggerate their World War II body counts and their plight in pro-fascist Croatia during World War II. After the end of World War II, Tito, with the help of Western credits and loans, created a rather surreal multiethnic laboratory of expendable individuals in which different aspects of communist myths and semi-myths, starting from Stalinist-inspired economic centralism to communist self-management, were tirelessly tested. Ten years after Tito's death the Yugoslav laboratory ran out of steam and the Yugoslav bomb went off – with the consequences now known to everybody.

Immediately prior to the dissolution of Yugoslavia in 1991, the Serbian political class began suspecting Croat intellectuals of having

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embraced historical revisionism, and became increasingly irritated by the former historian, now president of Croatia, Franjo Tudjman. In his books, Franjo Tudjman questioned the official communist historiography and the disproportionate percentage of ethnic Serbs in the Yugoslav communist administration.[7] Arguably, one may say that the war in former Yugoslavia, before it hit the ground, had been polemically waged in the late 1980s and in the 1990s by Croatian and the Serbian journalists, who may have provided an additional reason for the future spiral of violence. On a larger systemic level, the process of 'perestroika' and decommunization of the ex-Soviet Union, which about that time swept over Eastern Europe, further added to the delegitimization and legal deconstruction of ex-Yugoslavia.

Also, the dissolution of ex-Yugoslavia and the subsequent war was waged by the wrong media perceptions of one ethnic group against the other. Within the context of this analysis, it would be inappropriate to put the blame on nationalist Serbs only, while avoiding the analysis of the Titoist violent heritage. Neither is it correct, as the Serbian government-run media reported on the eve of the conflict, that Croatia was run by pro-fascist ustashis bent on recreating a replica of the profascist state of Croatia which existed from 1941 to 1945. Naturally, a panic-stricken Serb population, living in Croatia, after having been whipped into a frenzy of fear and hatred against Croats by the Belgrade-run media, concluded that the new and democratically elected government of independent Croatia was indeed staffed by unrepentant neofascists. This in hindsight, may seem far-fetched, given the large percentage of high Croat officials who were former communists and who harbored until 1990 rather strong pro-Yugoslav feelings.

The Serbian state-sponsored myth of re-emerging Croat ustashis-fascists, while being embraced particularly by local rural Serbs living in Croatia, was also popularized by some journalists in the Western media, which, additionally, led to yet another spiral of hatred and violence, and which further corroborated local Serbs' fear that the

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[7] Franjo Tudjman, *Nationalism in Contemporary Europe* (New York: Columbia University Press, 1981), p. 162-163. Also, Velike ideje i mali narodi, (Zagreb: Matica Hrvatska, 1996) pp. 313-328.

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new Croatia would treat them as second class citizens. In the Serb perceptions, the surreal image of a new and democratic state of Croatia corresponded to their first image of Croatia, i.e. that the first and last time Croatia was independent was during World War II in the form of a Nazi puppet state.[8]

One may conclude that the past war in Croatia and Bosnia-Hercegovina was primarily a war of false and self-serving ethnic perceptions, coupled with different nationalist myths, which were raised to their paroxysm as the war took momentum. Various Western reporters, while trying to sound impartial by sometimes rebuking Croatia's young democracy as profascist, added only more fuel to the burning Balkan fire. Unquestionably, at the beginning of the Serb-sponsored Yugoslav Army aggression, almost the entire Croat population of different political persuasions stood behind Tudjman and his government. Likewise, few Serbs at the beginning of the Serb rebellion in Croatia and of the Yugoslav Army aggression on Croatia and Slovenia, openly challenged Serbia's President Slobodan Milosevic's expansionist dream of "Greater Serbia."

Why did a country that enjoyed a relative popularity in Western intellectual circles have such a violent break-up? Could one argue that the legacy of the non-aligned Yugoslavia was a make-belief illusion where appearances surpassed reality; where multicultural illusions preceded the constant multicultural delusions? Naturally, even a passing observer may now, in retrospect, ask questions about the role of Western intellectuals in keeping afloat communist Yugoslavia during the cold war. Should one partly blame, let us say, the German and French left-leaning intellectuals, many of whom in the late 1970s and 1980s continued to believe in the "third option" of Titoist socialism with a human face? It may also be argued that the past war in the Balkans, and in Bosnia-Hercegovina, was basically a war between former communist elites, which were vicariously brought to life by the West, which had for decades preached unity and integrity of Tito's Yugoslavia. When the Serbian-dominated Yugoslav Army started the aggression in 1991 against Slovenia and Croatia, it

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[8] See A.M. Rosenthal, "Why Wink at Croatian Fascism?", *The International Herald Tribune*, April 16, 1997, and my response, "Croatia, Then and Now," in (Letters to the Editor), *The International Herald Tribune*, April 18, 1997.

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seriously thought that international law and the international community would be on its side and that Serbs must salvage the Yugoslav state against what the Serbian government-run media dubbed "Croat fascist separatists." It may be argued that had some non-communist government been in place, the scenario of Yugoslavia's disintegration may probably have taken a different, less violent, almost Czech-like confederal turn.

The behavior of Yugoslav intellectuals and some foreign journalists was far from calming, even prior to the conflict. This raises a question regarding intellectual responsibility and juridical integrity of Western opinion makers, particularly now against the backdrop of the current much-publicized war crimes trials at the United Nations International Tribunal in the Hague, where some Serb, Croat and Bosnian Muslim suspects are indicted for human rights violations committed during the conflict. A question can also be raised: should one try to blame the apparatchiks of the former Titoist Yugoslavia for having created a climate of mutual interethnic suspicion and terror which later led to war, before convicting ex-belligerants in the Hague for crimes that were indirectly the belated fall-out of those same communist apparatchiks? What does one take as the commencement of the crime, and in which lapse of the Yugoslav time? If some suspects in the Hague are being indicted for crimes they committed recently in Bosnia-Hercegovina, should one not at least consider punishing some former Yugoslav communist judges and attorneys, many of whom are still alive and active today, and who often committed gross human rights violations against former political dissidents in former communist Yugoslavia?

These academic questions are more delicate than they appear on the surface, because all countries in post-communist Europe must still face the "suppression of their historical memory" (*Geschichtsbewaltigung*), and come to terms with their violent communist past. In the eyes of many Serb intellectuals, Tudjman's books smack very much of revisionism, with which the democratic Federal Republic of Germany has had a very unsavory experience. Be this as it may, it is often forgotten that ethnic cleansing, mass terror, etc., did not begin with the Serbs, Croats or Muslims in 1991. The early Titoists wrote the blueprint for ethnic cleansing and for the Yugoslav Army aggression on Slovenia and Croatia by practicing it themselves in 1945, and ethnic cleansing against Croats, ethnic Germans,

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Hungarians, and Italians in 1946.[9] One may also argue that some Serb and Croat war crimes suspects today being tried in the Hague may also have some vague notion of these historical parallels. If their communist predecessors committed crimes with more or less international impunity in Titoist Yugoslavia, what is the point of having them now cross-examined by the prosecutors of the international community?

The war may be over in Croatia and Bosnia-Hercegovina but the communist mindset adds an additional painful problem to the highly complex post-Yugoslav drama. Of course, communism as a programmatic ideology is dead and gone in the states that emerged from the ruins of ex-Yugoslavia. Yet one can notice no substantive change in political culture of its disenchanted citizens. Constituents and the political class all over post-communist Eastern Europe suffer from an identity crisis. 'Homo sovieticus' lives on – along with little regional and communal 'Homo balcanicus'– albeit with all necessary democratic rhetoric. In short, despite the official legal collapse of former communist countries in the region, the heritage contrives that "communist despotism borrows from the little tyrant which is in every person – thereby setting one person against the other."[10] Despite its shortcomings, communist totalitarianism in Titoist Yugoslavia provided psychological security, economic predictability and the culture of sloth. Naturally, this only poses additional problems for the speedy democratization of the new countries in the region, and may in the near future lead to another, albeit different crisis.

Each democracy, as citizens in Western Europe know well, requires civic effort, tolerance, and a respect for the civil rights of different-minded citizens. In former communist Yugoslavia, just like in all other communist countries, those Western democratic notions were totally disregarded. The decades-long mental terror of communism accompanied by the social and cultural levelling of the masses, resulted in negative sociological selection and the subsequent birth of the culture of duplicity. All new states built on the ruins of communist Eastern Europe, and especially the citizens of former

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[9] Josef Beer, *Weissbuch der Deutschen aus Jugoslawien. Ortsberichte 1944-1948.* (Muenchen: Universitas Verlag, 1992).

[10] Claude Polin, *Le totalitarisme*, (Paris: PUF, 1982), p. 121

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Yugoslavia, are facing these devastating psychological problems. Despite the fact that communism in Yugoslavia enlisted the support of only a small minority of its citizens, it created a culture of mendacity, which continues to plague broad segments of citizens. The lack of civic responsibility, the lack of a real sense of new statehood, simply cannot be replaced, as some Western leaders naively think, by vague and often abstract forms of ready-made democratic formulae, made in the European Union or America.

In his study of the communist mindset, Alexander Zinoviev noted that Western observers make a mistake by using paradigms and models valid for the West, but unacceptable in analyzing communist societies.[11] This is particularly true for the heritage oBalkan clannishness and clientelism, which found its ideal expression in communist Yugoslavia. Western observers also make a mistake by suspecting politicians in the region of being inclined to authoritarianism and heavy-handed rule. This does not appear correct, considering, based on the above analyses, that citizens in the region, due to their communist heritage, have a poor notion of parliamentary democracy and almost no sense of interethnic tolerance. Eastern Europeans in general, and the diverse mixture of ethnic groups in the new and hybrid state of Bosnia-Hercegovina, in particular, continue to display servility and awe towards raw power. The old communistic practices of double deals and paranoid fear that everybody is plotting against everybody else may be a direct result of a Titoist totalitarian spirit mixed with ancestral communal village ("komsiluk")-like behavior. It will likely take decades before true democratic societies emerge in the region.

Tomislav Sunic, a Croatian diplomat and former political science professor in the USA, is the author of *Titoism and Dissidence* (New York: Peter Lang, 1995).

[11] Alexander Sinowjew (Zinoviev), *Die Diktatur der Logik* (Muenchen: Piper Verlag, 1985), p. 148.

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Man
Between Past and Future

BRUNETTO CHIARELLI

University of Florence, Italy

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Genetic Similarity Theory and the Roots of Ethnic Conflict

J. Philippe Rushton[1]
University of Western Ontario

In response to the jointly established American and Canadian Psychological Associations' (APA/CPA) "Initiative on Ethnopolitical Warfare," the author discusses his Genetic Similarity Theory of ethnic nationalism. He shows that genes influence why people tend to marry and associate with others like themselves. The important pull of genetic similarity can be felt in small groups and even large ones (national and international). The reason people seek genetic similarity and fear and avoid dissimilarity is to be found in the sociobiology of altruism. Altruism to genetically-similar others (extended kin) is an evolutionary mechanism which evolved in order to help replicate similar genes. Xenophobia is to be perceived as the obverse concomittant of human altruism, and ethnic nationalism as a force inherent in human nature.

Key Words: Genetic Similarity Theory, altruism, ethnic nationalism, xenophobia, sociobiology.

The politics of ethnic identity are increasingly replacing the politics of class as the major threat to the stability of nations. In the decades since World War II many have hoped that economic and educational development would gradually reduce interest in local nationalisms and promote the growth of more universalistic societies. However, As Connor (1994) points out, there is now a growing lack of faith that education, modernization, and enhanced communication are sufficient to lead to the assimilation of communal groups into "new nations." There are few examples of significant assimilation taking place since the advent of the age of nationalism and the principle of self-determination of nations. This suggests that the world will face continuing upheavals as an unending chain of peoples rise to ethnic self-consciousness.

Although ethnic struggles are widespread in the world today,

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most explanations seem shallow. The rise of nationalism in the former Soviet Union and eastern Europe seems to defy explanation. Only weak accounts are given for the conflict between Tutsis and Hutus in Rwanda, Hindus and Muslims in India, Croats and Serbs in the former Yugoslavia, or Blacks and Whites in the U.S. Experts also fail to consider any downside to current U.S. immigration policies.

With ethnopolitical conflicts ravaging societies in many different regions, the American Psychological Association (APA) and the Canadian Psychological Association (CPA) recently established a joint "Initiative on Ethnopolitical Warfare" to investigate the psychological causes of this most vicious of the grim visages of war (APA/CPA, 1997). Psychological analyses of the causes of ethnic strife have generally been neglected relative to analyses of the better known and measured political, cultural, economic, historical, and religious factors. Psychological explanation is made especially difficult since the rival groups construct very different histories of the conflict, and all parties see themselves as victims whose story has not been told.

In *Race, Evolution, and Behavior*, this author explains Genetic Similarity Theory. Genetic likeness is the glue that holds most personal relationships together. Genetic similarity is the biological basis for ethnic nationalism.

People naturally choose those who are genetically similar to themselves – as spouses, friends, associates, and even political leaders. Similarity is nature's sign that a stranger is a friend, not a foe. It indicates compatibility in goals and temperament as well. It is natural that genetically — and racially — similar people feel strong ties to their group.

Genetic Similarity Theory explains why patriotism is almost always seen as a virtue and an extension of family loyalty. Group members have 'ties of blood' to each other that make them 'special' and different from outsiders. The need to identify and to be with one's own kind is a big part of human nature.

Ethnic consciousness is rooted in the biology of altruism and mutual reciprocity. It enables a person to replicate his genes more effectively because fellow ethnics carry copies of the same genes and therefore benefit from ethnic favoritism. Ethnic nationalism and xenophobia are thus in their way concomitants of altruism.

Ethnic identity and ethnic favoritism are strategies that have

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Expanding one gene pool is sometimes done at the expense of other gene pools. History shows how peoples and cultures displace one another and fight for dominance. To understand why, we need to know about altruism in other species.

Evolution of Altruism

Altruism (behavior carried out to benefit another at a cost to the individual) has long posed a problem for theories of human nature. Animals show altruism through parental care, warning calls, common defense, rescue behavior, and food sharing. Altruism involves sacrifice. Sometimes the altruist dies. For example, when bees sting intruders while defending their hive, the entire stinger is torn from the bee's body. Stinging an intruder is an act of altruistic self-sacrifice.

Charles Darwin saw that altruism was a problem for his theory of evolution. How could altruism evolve through "survival of the fittest" if altruism means self-sacrifice? If the most altruistic members of a group sacrifice themselves for others, they will have fewer offspring to pass on the genes that made them altruistic. Altruism should not evolve, but selfishness should.

The problem of altruism was solved by *kin-selection* theory. It states that evolution is about *inclusive fitness*, not just individual fitness. It is the genes that survive and are passed on. Some of these same genes will be found in siblings, nephews, cousins, and grand-children as well as in offspring. Siblings share 50%, cousins about 12% of their genes. So when an altruist sacrifices its life for its kin, it ensures the survival of their common genes.

I have proposed Genetic Similarity Theory to go beyond "kin" and explain why people help spouses, friends, neighbors, and fellow ethnics. (See the 1989 issue of *Behavioral and Brain Sciences* for a summary and debate, as well as my 1995 book.) Genetic Similarity Theory explains assortative mating, or why "like mates with like," which kin-selection theory cannot. Assortative mating is not just found in humans. it occurs in insects, birds, monkeys and apes. It is even found in plants. Preferring similar partners requires being able to detect degrees of genetic similarity in others.

There is dramatic evidence that many animal species do detect genetic similarity. A guard bee blocks the nest to prevent intruders from entering. When bees of 14 degrees of genetic closeness to the guard are tested as intruders, only the more genetically similar

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intruders get through.

In frogs, tadpoles are separated before hatching and reared in isolation. When the tadpoles' siblings are placed at one end of the tank and their non-siblings in the other, the tadpoles move to their sibling's end of the tank.

Squirrels produce litters that contain both siblings and half-siblings. Even though they have the same mother, share the same womb, and inhabit the same nest, full-siblings fight less often than do half-siblings. Full siblings also come to each other's aid more often.

Choosing Similarity

Choosing husbands and wives and best friends and social partners are some of the biggest decisions we make. They affect our social life and our reproductive success. There is a strong tendency to choose similarity. Friends of either sex, as well as mates, resemble each other in many ways. Similarity is greatest on demographic variables (about 0.80), next most on social attitudes (about 0.60), then on IQ scores (about 0.40), and least on physical and personality traits (about 0.20).

Evolution has also set an upper limit on "like marrying like" – incest avoidance. Too close genetic similarity between mates increases the number of harmful genes. The best mate is one who is genetically similar but not a close relative.

Blood tests show that human mates and friends are genetically close. In one study, couples who produce a child together were 52% similar, but random couples were only 43% similar. In another study, best friends were 54% similar to each other on these blood tests, while random pairs were only 48% similar.

Spouses

But how can we know for sure that social partners are drawn to each other because they are able to assess genetic similarity? The answer is clear, but technical. Both spouses and best friends pick each other based on the most heritable traits, not the most obvious ones.

While almost all traits are inherited, some are more heritable than others. Here are some heritabilities: for physical traits, 80% for finger length vs. 50% for bicep size; for intelligence, 80% for the general factor vs. less than 50% for specific abilities; for personality, 41% for liking to read vs. 20% for having many hobbies; and for

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attitudes, 51% for agreement with the death penalty vs. 25% for agreement with Bible truth.

Partners are most alike on the most heritable items. Spouses resemble each other on average about 0.15 on physical traits. The range of values around 0.15 shows spouses are more similar on some traits than on others. The big point is that spousal similarity and heritability vary together. The more heritable a trait, the more spouses resemble each other on that trait. Spouses have chosen each other on the basis of genetic similarity.

These results cannot be explained by culture theories. Genetic Similarity Theory and Culture Theory of mate choice make opposite claims. Culture Theory claims that similarities between spouses will be greater on items that spouses are able to grow similar on because of shared experiences (e.g., calf and neck size, after shared diets and exercise). Genetic Similarity Theory, on the other hand, claims the similarities will be greater on items that are more heritable (e.g., wrist size and middle finger length, not easily changed).

Spouses resemble each other more on mental ability tests with high heritability than on tests with low heritability. Again, the results support Genetic Similarity Theory, not Culture Theory. Culture Theory wromgly predicts that similarity will be greater on tests easily modified through shared experience (e.g., reading together and building vocabulary).

The same results are found for personality traits. Similarity is directly related to heritability. Spouses choose their partners based on genetic similarity.

Family Members

Identical twins work harder for their twin than do fraternal twins. Identicals also show more physical attachment and express more affection. They also show greater loss when one twin dies. This makes sense because identicals are genetically more similar to each other than are fraternals. Happiness in a marriage is predicted by the genetic similarity of the partners. The items that best predict a good marriage have the highest heritability. Parents grieve more for children who resemble their side of the family.

Best Friends

Friends also choose each other based on genetic similarity.

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Similarity between friends is greater on the more heritable items. This again supports Genetic Similarity Theory, not Culture Theory.

Ethnic Identity

The pull of genetic similarity does not stop at family and friends. Group members move into ethnic neighborhoods, and join in clubs and societies. Since people of the same ethnic group are genetically more similar to each other than to members of other groups, they favor members of their own group over outsiders.

Even very young children often show a clear preference for their own ethnic heritage. In fact, the process of making racial groupings results from a natural tendency to classify people into "kinds." Children quickly begin to sort people into "basic kinds" by sex, age, size, and occupation. Experiments show that at an early age children clearly expect race to run in families. Very early in life, a child knows which race it belongs to, and which ones it doesn't.

Culture actually builds on genetic similarity. Patriotism is preached by using kinship terms. Countries are called the "motherland" or the "fatherland." Unions and churches call their members "brothers" and "sisters."

Identity is a powerful force in human affairs. Ethnic favoritism and ethnic nationalism can lead to forms of self-sacrificing altruism. This explains why ethnic insults can so easily set off a riot.

Gene Wars and Culture Wars

Genes often have effects that extend beyond the body. In non-human animals, forms of culture like beaver dams and ant hills are handed down from parent to offspring. Analogously, genes incline people to learn those ideas that increase their genetic fitness. Nationalism, religion, and class interests are to some extent cultural 'houses' that shelter people and help to replicate their genes.

Often a dominant group attempts to weaken other groups by promoting ideas that work to the dominant group's advantage and to the other group's disadvantage. People can be coerced into working for other groups. Some cultures benefit one gene pool more than its rivals. This forms a basis for culture wars. "Culture wars" are really undeclared "gene wars."

Cultures do arise which are "lethal" to the gene pools adopting

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them. For example, the Shakers were a religious sect that considered sex to be so sinful that it imposed celibacy upon even its married members. This idea was nonetheless successful in replicating itself through several generations. New adherents were recruited largely via adoptions. The member's genes, of course, failed to replicate.

Adopting some cultures can be considered a form of *unilateral genetic disarmament*. This would be the case if some groups chose multi-culturalism and genetic amalgamation while their competitors maintained a cultural purity. The gene pool for the first groups would cease to exist while those for the other groups would expand.

The gene pool affects how easily an ideology is adopted. The ideology then affects relative gene frequencies. Some genes thrive better in some cultures than they do in others. Religious, political, and class conflicts become heated because they affect genetic fitness. Karl Marx did not take his analysis far enough: Ideology may be the servant of economic interest, but genetic interest is master of both.

Campus and Religious Crusades

Over the last 50 years, American universities have been laboratories of changing norms, 'racial' and 'religious' quotas, and ethnic rivalry. This situation is even more tense in other countries. In Africa, the Kenyan government has warned lecturers and administrators at the University of Nairobi to stop giving higher marks to students of their own tribe. In Sri Lanka, members of the Tamil minority have to be given police protection.

This author first noticed the ethnic cultures at American universities when he spent six months at the University of California, Berkeley. The contrast with my mostly White Anglo-Saxon Protestant (WASP) home base at the university of Western Ontario was striking. Not only did ethnic groups sit together, but they often banded together for political action. Black newspapers on campus wrote about the plight of blacks in London, England, 7,000 miles away, and about the case of child murders in Atlanta. Jewish student newspapers, on the other hand, wrote about Israel, and dissident Jews in Russia, and appealed for money to help airlift the Ethiopian Jews to Israel. (Many now live in Israel and have become a 'tribe' of their own.) The Chicanos wrote about bilingualism and how to make it easier to immigrate to the U.S. from Mexico and Central America. Group membership clearly influences which issues we think are

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important and what position we take.

Modern scientific testing shows that these examples of 'religious,' 'class,' and 'linguistic' groups are linked to genes. Genetic Similarity Theory predicts that many classic divides will turn out to be genetic.

Studies by Professor Bonne-Tamir of Tel Aviv University show that Jews are genetically alike even though they have been scattered around the world for two millennia. Jews from Iraq share more genes with Jews from Poland than either group shares with the non-Jewish groups they lived with for centuries. This is also true of Jewish immigrants to Israel from Germany and the former Soviet Union and even Libya. (The Ethiopian Jews, however, are not genetically 'Jewish').

Jews, Japanese, East Indians, Africans, and all other 'gene pools' tend to adopt ideologies that work in their genetic self-interest. These ethnic goals are rarely presented as pure genetic self-interest. Instead they are typically masked by high ethical terms, no matter how obvious to opponents. Just think of the competing claims of the Arabs and the Israelis, the Afrikaaners and the Bantus. Rival groups write their own very different history of the conflict and they see themselves as victims whose story needs to be told.

We must examine the genetic consequences of political action and find out who benefits and who loses. Political issues are explosive when survival and reproduction are at stake. Consider the growth of right-wing Christian fundamentalism. It represents a reaction to the moral breakdown of society. Because of trends in the mass media and educational system, many religious people believe they now live in a hostile culture. The issue on which they are most politically active is abortion. If estimates of genetic similarity could be obtained, I predict that fundamentalists are close to each other and to the basic Anglo-Saxon gene pool. I also predict that 'Liberals' who are pro-choice on abortion are genetically more distant from the WASP average. What percentage of the estimated 30 million women having legal abortions in the United States since 1973 were Anglo-Saxon?

Global Politics

In a 1986 article in *Politics and the Life Sciences* I predicted that the role of genetic similarity in geopolitics would increase in the U.S. and U.S.S.R. Both superpowers had large ethnic minorities with high

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birth rates. The ruling groups could not maintain their positions. One reason the Soviet Union invaded Afghanistan was to suppress Moslem fundamentalism. The Muslim minorities in the U.S.S.R. had the highest birth rates and had displaced the dominant Russians in many areas. Today, the southern republics are free nations and the U.S.S.R. is no more.

Although I was not the only one making these predictions, most Soviet experts were stunned by how fast the U.S.S.R. and Eastern Europe broke up along ethnic lines. However, I take little comfort from the confirmation of these forecasts about the late U.S.S.R. In Europe and North America, power shifts and turmoil can be expected from the contrasting birth rates of Whites and non-Whites.

In 1950, the population of the United States was 88% White, 10% Black, and 2% Other. Today the population is 71% White and 29% non-White. By the year 2050, Whites will be only 49%, and simply the largest minority group. Canada, Australia, and Western Europe have policies similar to the U.S.A. In Canada, non-Whites will triple in number over the next 20 years to 7.1 million people, one in five Canadians. Japan, however, has a minority population of less than 1%, allows no immigration, and will remain ethnically unchanged for the time being. China, a new superpower, has policies similar to Japan's.

Back to the Future

Attempts to suppress ethnic feelings regularly fail because such feelings are part of human nature. Of course, genetic similarity is only one of many influences that operate in politics. Ethnic relations are complex and never caused by just one factor. Fellow ethnics do not always stick together, and conflict between groups is not inevitable. Genetic similarity influences social behavior in small groups and even in large ones, both national and international.

In his classic statement on the rights of people to govern themselves, John Stuart Mill (1951, p. 486) proposed that: "Where the sentiment of nationality exists in any force, there is a prima facie case for uniting all the members of the nationality under the same government, and a government to themselves apart .... One hardly knows what any division of the human race should be free to do if not to determine with which of the various collective bodies they choose to associate themselves." Sociobiology now tells us why J. S.

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Mill was right – ethnic nepotism is an extension of an underlying genetic imperative.

Ethnic identity is based on genetic similarity. It may sometimes be hidden, but it cannot be eradicated. Better it should be understood. As economic opportunities grow and environments become more equal, people become freer to choose those cultures that are maximally compatible with their innate preferences. The world is currently witnessing a revival of ethnic nationalism despite the technologically-pressured trend toward globalization and universality. Genetic Similarity Theory explains why.

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Economic Reform in China

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The China Miracle: Development Strategy and Economic Reform
(A Friedman Lecture Fund Monograph)
Justin Yifu Lin, Fang Cai, and Zhou Li
The Chinese University Press, Hong Kong, 1996

The Chinese Economic miracle is that since economic reform begun (late 1978) the economy has grown at an average of about 10%, a rate that was far above the rates achieved in the same period by both developed and undeveloped countries, and far higher than China had obtained during earlier periods. Given the 1.2 billion people in China whose welfare was greatly improved, this may be the world's major major economic success story. The task the authors, Justin Yifu Lin (Peking University), Zhou Li, and Fang Cai, (both of the Chinese Academy of Social Science) is to explain first why China's early attempts at forced industrialization failed, and then to explain the logic of the reforms that produced this remarkable surge in growth.

Their argument is that basic economic theory was ignored. Although China was an undeveloped country with an abundance of labor, and hence a comparative advantage in labor intensive products, the leadership adopted what they call the Great Leap Forward Strategy, a strategy of giving priority to heavy industry. Because these industries are capital intensive, not labor intensive, doing so meant failing to take advantage of China's comparative advantage in labor intensive products.

Because this heavy industry strategy would have been unprofitable and unfeasible with market-set prices, the Chinese leadership had to distort the prices a free market would have had to establish, and underprice capital, foreign exchange, transportation, and the natural resources used by these industries. Because the

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resultant prices did not correspond to actual resource scarcity, the management of the economic enterprises could not be told to maximize profits, but had to be given detailed direction from government agencies. This in turn required a massive and sluggish bureaucracy to manage the economy and to direct resources to the preferred uses. Lacking the information the enterprises had, the government ministries could not make decisions nearly as well as a market could. Labor compensation rates were centrally set and not controlled by the enterprise management, which seldom were able to fire workers. This made it hard to motivate workers.

Why was this system adopted? The authors blame the adoption on various academic writers who pointed to the large role heavy industry played in the long industrialized countries of North America and Europe (confusing a result of development with a cause of it), and to the example of the Soviet Union, which China emulated in the early years. Other factors less discussed may have been the utility of heavy industry in producing military weapons, and the ego-gratification large steel mills and similar projects offered to the leadership.

Although a more equal distribution of income, especially between rural and urban areas, was one of the announced objectives of the communists, China made little progress towards this goal. It is pointed out that a major reason for this was the emphasis on heavy industry, which was capital intensive and foreign exchange intensive (China in the early years produced little of the equipment required).

As a result, even massive investments failed to generate many new jobs, and failed to provide the needed employment opportunities for the vast population in China's rural areas. Since the heavy industry was typically located in urban areas, the heavy industry drive did little for China's poverty problem which was concentrated in the rural areas. In contrast, in Taiwan and Korea, where the development was market driven and responded to these countries comparative advantage in labor intensive industries, the benefits of modernization included a reduction in income inequities and increases in rural incomes. The reason was that the rapidly growing labor-intensive industries could absorb these countries' surpluses of labor.

China was not alone in adopting a heavy-industry led modernization program. The Soviet Union, India, and many other

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countries adopted such strategies. It is argued the results were similar in all of these countries, with slow growth and slow increase in consumption, and relatively little progress in reducing rural poverty. Several small countries that originally tried this strategy abandoned it, (Korea, Taiwan, Singapore), and went to a more market led approach, which utilized their comparative advantage in labor intensive industries. Along with Hong Kong (which had never tried a heavy industry led strategy) these became the "Little Dragons" and enjoyed a long period of fast economic growth, suggesting they were doing something right. China's shift to a more market-oriented economy was a slow process with reforms made gradually in contrast to the Big Bang of sudden price decontrol experienced in Russia and other parts of Eastern Europe. Which approach to adopt was the subject of much discussion among economists. But far the Big Bang approach in Russia and Eastern Europe has not brought rapid growth, and instead seems to have brought them misery.

The Chinese institutional shift has been relatively slow, with reforms frequently being tried in a few cities or regions before being extended to the rest of the nation (a sensible idea that the constitutions of the U.S.A. and most western societies would prohibit).

The first big success was in agriculture. The communists had collectivized agriculture. At the micro-level this meant that peasants were paid a wage for working (actually a share of total profits) that varied little with how hard they worked, or how well. Management was centralized and the collective farm had the problem of supervising workers ensure that they worked hard. However, because agricultural activities take place over a large area, supervision could be only so effective. Workers, realizing this, did not work very hard, and per capita production and consumption of food grew slowly. (The Russian joke was that they pretend to pay us and we pretend to work).

The first major Chinese agricultural reform was the household-responsibility system, where a peasant household was allocated a certain area of land and contracted to supply a certain amount of produce to the state, and were then allowed to keep and sell what they produced beyond that amount (in economic terms this was like crop-sharing or renting the land to the peasants). It meant that hard work and initiative were rewarded, and agricultural production

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jumped accordingly. Once it was clear from some initial experiments that this worked, the measure was more widely adopted. The peasants were better off and the food supply increased without any major interest group being worse off, and the political basis was set for further reforms. The process by which this reform was introduced illustrates how reforms were tried out on a small scale and then expanded, as well as some of the ideological difficulties encountered. Household-responsibility systems had been tried earlier from time to time but usually denounced as a "return to capitalism." The first legalization was back-handed (Sept. 1979) saying "apart from some special needs for sideline production and for isolated households in remote, inaccessible areas ... the adoption of the household-responsibility system is not permited," indirectly permitting it to be adopted as an exception. The system was introduced to increase production and to help solve the problem of ensuring adequate subsistence in these areas.

Toward the end of 1980, the policy was relaxed to "in those remote mountainous, poor or backward regions ... if there is a demand for adopting the household output-quota contract system, the government should support he general public's demand." This resulted in the system becoming universal among the poorest production teams and where adopted the agricultural output expanded considerably. When the government observed this, it first relaxed the restrictions, and then removed them entirely in 1982. Finally, in 1983, it declared that "The household responsibility system is one of the managerial modes in the socialist collective-ownership economy which consists of diversified management and unified management. . . There is a substantial difference between its nature and that of the small private individual economy in the past, and this should not be confused.ö (see pp.132-133). With this ideological reinterpretation, the system soon became universal. This illustrates how ideology slowly gave way to realism.

The idea of giving enterprises greater freedom was extended to state-owned urban factories, and after they had met contractual obligations to the state, these were allowed to keep a fraction of what was left over for investments of their own choice. Under the standard Chinese planned economy system, all profits and depreciation went to the central government, from whom investment funds were

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allocated back to the state enterprises. There was little incentive for workers to work hard or for managerial efficiency. The contract responsibility system resulted in a degree of improved efficiency, and generated further support for reforms.

The state enterprises typically used their flexibility to produce goods that were the most profitable, which were often consumer goods that could be produced by labor intensive methods. However, because of the arbitrary nature of prices set by the state (frequently with goals of subsidizing certain industries) this transfer of resources was not always in what was considered a desirable direction. This created pressure to reform prices, allowing them to be set by the market so as to more closely reflect real scarcity or abundance of resources.

Rather than deregulating prices suddenly (the big bang approach used in Russia and other countries), Chinese deregulation was gradual. In some cases this was achieved by increasing supplies until goods could no longer sold at the official prices and then letting competition bring the prices down. This happened with many consumer goods such as watches. A dual price system was frequently allowed to emerge. The planned quantities of goods were sold through the channels provided for in the plan, while enterprises were allowed to purchases or sell extra amounts through free market channels.

For agricultural products the farmers would sell their contracted amounts to the state at the state price, but were free to sell the excess production at market prices to those who were willing to pay those prices. This dual price system had the advantage of permitting a gradual approach to a market system, and providing market set prices, which could be used as a guide in revising the state set prices. As state prices approached market prices, the foundation was set for final deregulation in which the prices were freed.

One of the costs of this system was that it led to what is sometimes called rent-seeking behavior and corruption. It was virtually always profitable to make something if the raw materials could be obtained at the low state prices, and the outputs sold at free market prices. Thus must enterprise effort went into obtaining inputs at favorable prices and selling them at deregulated prices, or in some cases obtaining items at the regulated prices and selling the same items at the deregulated price to a firm who needed them. The

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temptation to bribe officials or those in other firms became much greater as the potential profits grew. At the peak of the communist system when the only sources of income were the firmÆs salary, it would have been hard to accept large bribes without living beyond one means and attracting attention. With the emergence of a class of rich businessmen and the acceptance of disparities in income, it became easier to explain extra income and consumption away. Corruption became and remains a major problem.

A major innovation in China was the emergence of town and village enterprises. The original communist system had put heavy industry in urban areas, and left the rural areas to agriculture, even though they had much more labor than was needed for this. When permitted to organize their own factories (frequently in cooperation with foreign capital) they did so, operating outside of the state plan. They usually chose to produce consumer goods, which took advantage of the Chinese comparative advantage in labor intensive goods, buying raw materials at the free market prices and selling at free market prices. These proved to be typically more efficient than the state owner enterprises.

China suffered from disequilibrium at the macro level by which they meant that capital (especially in the form of bank loans) was underpriced relative to labor. This is seen as one of the areas that remain to be reformed. A major obstacle to reform here is that the profitability of many state enterprises would be hurt if they paid a market price for capital, and that these were typically well-connected with the relevant ministries. Yet reform in this area is needed if the market is to send the right signals to enterprises. It is argued that by conducting reforms in a gradual manner China avoided many of the dislocations that affected the reform process in Russia and elsewhere.

The early reforms benefited most groups in society and generated sufficient increases in income that it was possible to compensate at least some of those that were hurt. Furthermore, each partial reform created disequilibria and inefficiencies that could best be relieved by taking the next step in reform. In places this book has a textbook quality as it provides the economic theory (diagrams and all) to explain why a market allocation system that reflects a country's relative factor abundance (abundant labor for China) maximizes welfare.

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For a professional economist such as the writer, this is mildly annoying, although the theoretical sections are easily ignored. This might make the book usable for teaching purposes where the students had a special interest in China (including Hong Kong) and students could be shown the theory and how it was applied to real world issues. Also, in a few places there are unexplained references to details of the Chinese system that will not be known to the typical Western reader, but these are few.

Overall this appears to be a valuable book that will be of interest not only to those concerned with the economic wellbeing of the 1.2 billion Chinese, but to those interested in the problems of transition from a planned to a market economy (as in the former USSR and in Eastern Europe), and to those in other underdeveloped countries wondering how the Chinese Economic miracle was achieved. However, the book was published before the recent Asian financial crisis, and does not deal with the stimulating impact of the vast inflow of foreign capital and technology which followed these reforms, or the ongoing problem of internal financial reform and the comparative inefficiency of the remaining state-owned industry.

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